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The Bespeaks Caution Doctrine: Revisiting The Application of Federal Securities Law To Opinions and Estimates

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The Bespeaks Caution Doctrine: Revisiting the Application of Federal Securities Law to Opinions and Estimates

Royce de R. Barondes*

I. THE SAFE HARBOR FOR PROJECTIONS—RULE 175 UNDER THE 1933 ACT AND RULE 3B-6 UNDER THE 1934 ACT  ................................................................. 247

II. DEVELOPMENT OF THE BESPEAKS CAUTION DOCTRINE IN THE COURTS OF APPEALS ................................................................. 251
   A. Second Circuit ........................................... 253
   B. Fifth Circuit ............................................. 256
   C. First Circuit ............................................. 257
   D. Ninth Circuit ............................................. 258
   E. Sixth Circuit ............................................. 262
   F. Eighth Circuit ........................................... 265
   G. Seventh Circuit .......................................... 266
   H. Third Circuit ............................................ 267

III. APPLICATION OF THE OBLIGATION TO PLEAD FRAUD WITH PARTICULARITY TO CLAIMS CONCERNING OPINIONS OR ESTIMATES  .............. 269

IV. ANALYSIS OF THE BESPEAKS CAUTION DOCTRINE  ................................................................. 275
   A. Disclosure of Predictions and Cautionary Language Discharging the Obligation to Disclose Other Material Information  .......... 275
   B. Restriction of Bespeaks Caution Doctrine to Financial Information ................................................................. 276
   C. Facts Implying Absence of Good Faith or a Reasonable Basis .. 277
   D. Claims Implicating Mismanagement ................................................................. 281


The author participated in the provision of legal services to a number of issuers, underwriters, and placement agents in public offerings and private placements during the course of his employment with Cravath, Swaine & Moore. Some of those companies are parties to cases referred to in this Article, although the author did not participate in any of the transactions that are the subject of the cases described in this Article. This Article does not discuss two cases, In re Time Warner Inc. Securities Litigation, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,824 (2d Cir. Nov. 30, 1993), and In re Westinghouse Securities Litigation, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,750 (W.D. Pa. July 27, 1993), in response to the relationship between the author's former employer and the defendants in those cases. This Article reflects solely the views of the author.

This Article reflects developments in the law reported as of February 1994.

243
Disclosure of estimates and opinions, which are often referred to as "soft information,"\(^1\) has presented a number of difficult issues to courts, the Securities and Exchange Commission (SEC) and companies issuing offering materials or required to file periodic reports with the SEC. Although this type of information often consists of projections, historical financial statements also include this type of information to varying degrees. For example, a bank's statement of financial position requires specification of loan loss reserves and is therefore dependent on an assessment of future events (the timing and extent of repayment).\(^2\) Similarly, determination of the timing of a write-off of development costs will depend on the expectation of future sales.\(^3\) The disclosure issues raised by this type of information include the extent to which a company is permitted or even required to disclose this information and the scope of any liability arising from dissemination of the estimate or opinion.\(^4\)

1. The term "soft information" is defined in Victor Brdney, A Note on Materiality and Soft Information Under the Federal Securities Laws, 75 VA. L. REV. 723 (1989), as:

   (1) information that offers an explicit internal estimate of a corporation's future performance—e.g., projections of earnings, revenues, sales, or stock prices—which, if disclosed, would provide the public investor with the estimates of specially knowledgeable experts, and thus relieve the investor of the need to rely solely upon his or her own inferences about the future from such underlying data as are publicly available; (2) information that offers estimates of the present value of illiquid assets, e.g., appraisals which, if disclosed, would provide the public investor with specially knowledgeable expert inferences drawn from internal corporate information about the price to be received if the asset were sold, and thus relieve the investor of the need to rely solely upon his or her own inferences from available public information; and (3) information about merger negotiations in which a corporation is involved.

   \(^{Id.\ at\ n.2.}\)

   This definition is both over-inclusive and under-inclusive. The basis for imposing differing disclosure obligations with respect to "soft information" is that the information is the product of analysis requiring the exercise of judgment. Liquidity of an asset may provide an indication of the extent to which estimation of the asset's value involves judgments. Yet the range of values that knowledgeable individuals would attribute to some illiquid assets (for example, an interest in a partnership owning government securities) may be relatively small. Other estimates involving varying degrees of judgment, such as litigation exposure or probabilities of varying results in material negotiations outside the context of a merger, also are not addressed by this definition.

   Other commentators have noted that all reporting companies possess information spanning a continuum representing varying degrees of subjectivity, and the distinction between "hard" and "soft" information is the degree of subjectivity involved. See Bruce A. Hiler, The SEC and the Courts' Approach to Disclosure of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing Views, 46 MD. L. REV. 1114, 1116 (1987) (defining soft information as "information about a particular issuer or its securities that inherently involves some subjective analysis or extrapolation, such as projections, estimates, opinions, motives, or intentions") (citations omitted). See also Homer Kripke, Rule 10b-5 Liability and "Material" "Facts," 46 N.Y.U. L. REV. 1061, 1070 (1971) (referring to the examples of allowance for doubtful accounts and depreciation and stating, "First, we must note that most facts in a registration statement or similar document do not represent absolutes, but rather probabilities.").

2. See infra notes 118-26, 191-94, 254 and accompanying text.

3. See infra notes 41-54, 235-53 and accompanying text.

4. Commentators have increasingly used game theory to analyze whether companies should be permit-
Under section 11 of the Securities Act of 1933 (1933 Act), a company selling securities in a transaction registered with the SEC (i) pursuant to a registration statement containing an untrue statement of a material fact or omitting a material fact necessary to make the registration statement not misleading will be liable, (ii) to any person acquiring the registered security, (iii) for damages that exclude any decrease in value the defendant shows represents other than a decrease arising from the untrue statement or omission. The company's directors, other persons signing the registration statement, and the underwriters have a "due diligence" defense. However, the issuer does not have the same defense. Section 12(2) of the 1933 Act provides that persons offering or selling securities, whether registered or not, pursuant to false or misleading prospectuses are liable to purchasers for the consideration paid less income received. The elements of a claim for violation of Rule 10b-5 under the Securities Exchange Act of 1934 (1934 Act) in connection with the purchase or sale of securities.
are (i) a material misstatement or omission, (ii) scienter, (iii) damage, and (iv) causation. Although the Supreme Court has declined to decide whether recklessness would constitute scienter, courts of appeals have generally found recklessness to be adequate. In the context of disclosure of opinions or estimates, it is important to note that of actions under section 11 or 12(2) of the 1933 Act or Rule 10b-5, only actions under Rule 10b-5 require proof of scienter. Actions under sections 11 and 12(2) of the 1933 Act provide a defense to those making a reasonable investigation (except for issuers as to actions under section 11, who do not have that defense).

Applying these standards to disclosure of opinions and estimates raises additional issues. Courts have generally held that disclosure of an opinion or estimate implies a representation that the opinion or estimate has been formed on a reasonable basis, and that representation is considered a “fact” within the coverage of sections 11 and 12(2) of the 1933 Act and Rule 10b-5. To decrease the risk that an opinion or estimate

15. E.g., First Interstate Bank of Denver v. Pring, 969 F.2d 891, 901 (10th Cir. 1992), cert. granted sub nom. Central Bank v. First Interstate Bank, 113 S. Ct. 2927 (1993); Hanon v. Dataproducts Corp., 976 F.2d 497, 507 (9th Cir. 1992); Ackerman v. Schwartz, 947 F.2d 841, 849 (7th Cir. 1991). The Supreme Court granted certiorari in Central Bank to consider whether there is an implied right of action for aiding and abetting violations of Rule 10b-5 and whether recklessness satisfies the scienter requirement for claims alleging aiding and abetting a violation of Rule 10b-5. 62 U.S.L.W. 3028 (U.S. July 20, 1993). Even if the Court holds that there is no private right of action against aiders and abettors or that intentional misconduct is required to impose liability on individuals who aid or abet a violation of Rule 10b-5, the set of individuals to whom the recklessness standard would apply will be large, and the distinction between negligent conduct and reckless conduct will remain significant to that set of individuals.
17. See, e.g., In re Apple Computer Sec. Litig., 886 F.2d 1109, 1113 (9th Cir. 1989) (“[P]rojections and general expressions of optimism may be actionable under the federal securities laws.”), cert. denied, 496 U.S. 943 (1990); Isquith v. Middle S. Utils., Inc., 847 F.2d 186, 203 (5th Cir.) (“Courts in the past have consistently recognized that a defendant does not place itself beyond the reach of the securities laws merely by disclosing information that is predictive in nature.”), cert. denied, 488 U.S. 926 (1988); Marx v. Computer Sciences Corp., 507 F.2d 485, 489 (9th Cir. 1974) (“That a forecast, essentially a prediction, may be regarded as a ‘fact’ within the meaning of [Rule 10b-5] is settled . . . .”) (citation omitted). Cf. Friedman v. Mohasco Corp., 929 F.2d 77, 79 (2d Cir. 1991) (holding a statement in a press release describing debentures issued in a merger as having a specified value, in the opinion of investment banks, not actionable where there was no evidence that the investment banks were not of that opinion). But see Raab v. General Physics Corp., 4 F.3d 286, 289 (4th Cir. 1993) (holding that disclosing that “[r]egulatory changes . . . have created a marketplace for [a division of the registrant] with an expected annual growth rate of 10% to 30% over the next several years” was “puffing” and not actionable); Barrios v. Paco Pharmaceutical Servs., Inc., 816 F. Supp. 243, 246, 251 (S.D.N.Y. 1993) (stating with respect to projections, referred to in the placement memorandum “only as a mathematical illustration of the assumptions” . “it is well settled in this and a number of other jurisdictions that future presentations such as contained in the PPM are not statements of material fact on which an investor can rely.”); Greenberg v. Howtek, Inc., 790 F. Supp. 1181, 1185 (D.N.H. 1992) (“Statements about future events that are plainly expressions of opinion and not guarantees are not actionable under the federal securities laws.”) (quoting Haft v. Eastland Fin. Corp., 772 F. Supp. 1315, 1320 (D.R.I. 1991)). Similarly, the Supreme Court held that a proxy statement relating to a merger in which the board stated that it approved the merger because it permitted shareholders to achieve a “high” value and a “fair” price can be materially misleading under Rule 14a-9 under the 1934 Act, 17 C.F.R. § 240.14a-9 (1990), if the statement was made knowing its falsity. Virginia Bankshares, Inc. v. Sandberg, 111 S. Ct. 2749, 2759-60 (1991). Courts have held that the test of materiality under the various federal securities laws is the same. See, e.g., Flamm v. Eberstadt,
made with a reasonable basis will become actionable after it is disseminated solely because the future proves it to be inaccurate, both the courts and the SEC have promulgated doctrines that limit liability for this type of disclosure. The SEC has created a safe harbor from liability under the 1933 Act and the 1934 Act for certain projections filed with the SEC. Courts have addressed liability for disclosure of opinions or estimates that are not within that safe harbor, such as statements not made in documents filed with the SEC and opinions or estimates concerning matters not within the scope of the safe harbor. Some of those courts have developed a separate doctrine under which companies will not be held liable under those laws for disclosure that "bespeaks caution."

Some of the issues addressed in the SEC's adoption of the safe harbor also arise in an analysis of the Bespeaks Caution Doctrine. In Part I of this Article, the history of the SEC's adoption of that safe harbor is briefly reviewed. Part II of this Article chronologically reviews the Bespeaks Caution Doctrine as it has been discussed by the courts of appeals for the circuits that have considered the doctrine. Selected district court cases in those circuits are also discussed. The effect of the safe harbor and the Bespeaks Caution Doctrine are affected by courts' application of Federal Rule of Civil Procedure 9(b), which requires fraud to be pled with particularity. Part III of this Article briefly summarizes the application of that rule in cases concerning disclosure of estimates or opinions. The impact of the Bespeaks Caution Doctrine is then further analyzed in Part IV of this Article.

I. THE SAFE HARBOR FOR PROJECTIONS—RULE 175 UNDER THE 1933 ACT AND RULE 3B-6 UNDER THE 1934 ACT

The extent to which forward-looking information and other estimates and opinions may be disclosed in documents required to be filed with the SEC, or are required to be disclosed in those documents, has been evolving since the SEC revisited its longstanding policy. This policy prohibited inclusion of projections in those documents through

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814 F.2d 1169, 1174 (7th Cir.) ("[L]ike every other court of appeals we have taken the definition of materiality in TSC as suitable for the term wherever it appears in securities law."), cert. denied, 484 U.S. 853 (1987).

18. The truthfulness of a statement under the federal securities laws is to be judged as of the time it is made. Pommer v. Medtest Corp., 961 F.2d 620, 623 (7th Cir. 1992) ("The securities laws approach matters from an ex ante perspective: just as a statement true when made does not become fraudulent because things unexpectedly go wrong, so a statement materially false when made does not become acceptable because it happens to come true."). Nevertheless, if estimates or opinions prove to be substantially different from the actual events, the circumstances may support an inference that the estimates were fraudulent when made. See, e.g., Ouaknine v. MacFarlane, 897 F.2d 75, 81 (2d Cir. 1990) ("It is difficult to imagine how such events could have occurred if the defendants who controlled them had not actually intended to defraud."). Similarly, that an issuer is unable to make the first interest payment on bonds sold in a registered offering suggests careful scrutiny of the prospectus is warranted. However, a court dismissed federal securities law claims in such a case. In re Worlds of Wonder Sec. Litig., 814 F. Supp. 850, 855, 873 (N.D. Cal. 1993). See infra notes 107-12 and accompanying text.

19. The promulgation of the safe harbor has not prompted dissemination of projections in documents filed with the SEC by substantial numbers of companies. LOSS & SELIGMAN, supra note 8, at 635.

20. The history of the SEC's developing views on disclosure of this type of information has been extensively reviewed by a number of commentators and in court opinions. See, e.g., LOSS & SELIGMAN, supra note
at least February 1973. On April 28, 1975, the SEC issued a detailed set of proposed rules for the disclosure of projections. Those proposed rules would have required that any projections released to any person be filed with the SEC and thus made available to all investors. The proposed rules also would have provided a safe harbor for projections of revenues, net income, or earnings per share prepared in good faith and with a reasonable basis by companies that had been subject to the reporting requirements for three years.

On April 23, 1976, the SEC withdrew these proposals based on the number of technical issues raised in comments received by the SEC. However, based on the SEC's understanding that investors wanted to be advised of management's projections, the SEC published proposed guides under which the Division of Corporation Finance would review economic projections in documents filed with the SEC, without encouraging or discouraging dissemination of projections. In November 1977, the Report of the Advisory Committee on Corporate Disclosure to the SEC, which addressed projections among other matters, was released. On November 7, 1978, the SEC decided to


21. Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5362, 38 Fed. Reg. 7220 (1973). In that release, the SEC recognized the importance investors place on management's projections, expressed its concern that projections were at that time being disseminated on a limited basis, without access to all investors, and stated general propositions that would be incorporated in rules and releases to be issued in the future by the Division of Corporation Finance.


23. There were limited exceptions such as projections furnished to commercial lenders and furnished in preliminary acquisition negotiations. Id. That disclosure of projections is made to commercial lenders should not require their inclusion in a contemporaneous registration statement was recently recognized by a case in the Ninth Circuit. In re Lyondell Petrochemical Co. Sec. Litig., 984 F.2d 1050, 1052 (9th Cir. 1993).


25. Securities Act Release No. 5699, 41 Fed. Reg. 19,986 (1976). The proposed guides: (i) provided that management must have a reasonable basis for the projections; (ii) provided that the projections could be accompanied by an independent review; (iii) indicated that traditionally projections were given for revenues, net income, and earnings per share, and while extraordinary items might require selection of alternative line items, projections of sales without an income measure would normally be inappropriate; (iv) encouraged companies filing projections to disclose the assumptions or several projections based on varying disclosed assumptions; (v) stated that management should disclose whether it intended to update the projections; and (vi) stated that management should consider disclosure of the accuracy of its previous projections. The guides as proposed did not apply to "tax shelter investments." Id. at 19,987-88.

26. ADVISORY COMM. ON CORPORATE DISCLOSURE, 95TH CONG., 1ST SESS., HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION (Comm. Print 1977). The report includes a detailed analysis of
follow the Advisory Committee’s recommendation to encourage dissemination of pro-
jections by authorizing issuance of final guides of the Division of Corporation Fi-
nance and proposing a safe harbor for projections included in documents filed with
the SEC. The guides noted the Division of Corporation Finance’s position that dis-
closure of projected revenues without projected income generally would be mislead-
ing. The SEC adopted the final rules creating the safe harbors for projections, Rule
175 under the 1933 Act and Rule 3b-6 under the 1934 Act (collectively, the Safe Har-
bror), on June 25, 1979.

In general, the Safe Harbor provides that companies will not be liable under either
the 1933 Act or the 1934 Act for forward-looking statements of financial items,
management’s plans and objectives, and the underlying assumptions, if the statements
are made in good faith, with a reasonable basis, and made originally in a document
filed with the SEC or reaffirmed in such a document within a reasonable time. Because
courts have applied the Bespeaks Caution Doctrine to disclosure of information of the
type covered by the Safe Harbor, a review of the issues that the SEC addressed when it
adopted the Safe Harbor assists analyzing the Bespeaks Caution Doctrine.

Five aspects of the Safe Harbor deserve mention: (i) the standard applied to the
method in which the forward-looking statements must have been prepared (in good faith
and with a reasonable basis) to be within the Safe Harbor; (ii) the scope of those items
covered by the Safe Harbor; (iii) the party on whom the Safe Harbor places the burden
of proving that the standard has not been met; (iv) that assumptions need not be dis-
closed for the Safe Harbor to apply; and (v) its limitation to documents filed with the
SEC. First, the Safe Harbor makes no distinction between causes of action under the
1933 Act and the 1934 Act. As scienter is an element of private actions under Rule
10b-5 but is not an element of an action under sections 11 and 12(2) of the 1933 Act,
projections prepared without a reasonable basis but not prepared recklessly or with
knowledge of falsity are not actionable under the 1934 Act. The releases proposing and
adopting the Safe Harbor make no reference to the reason for adopting the same level
of culpability with respect to actions under the 1933 Act and the 1934 Act. The release
adopting the Safe Harbor notes, however, that a plaintiff who proves that the Safe Har-

the case law concerning the disclosure of estimates and opinions through 1976. Id. at A-330.
27. Securities Act Release No. 5992, 43 Fed. Reg. 53,246. The final guide was substantially identical to
the proposed guide, with the addition of a statement that companies should not discontinue providing projec-
tions without a reasonable basis (unfavorable expectations not being a reasonable basis). Id. at 53,250.
(1978).
(codified at 17 C.F.R. §§ 230.175, 240.3b-6 (1993)). The SEC’s views on disclosure of projections are reiter-
ated in 17 C.F.R. § 229.10(b) (1993). Safe harbors for actions under the Public Utility Holding Company Act
§§ 77aaa-77bbb (1988 & Supp. IV 1992), were adopted at the same time. 17 C.F.R. §§ 250.103A, 260.0-11
(1993). Actions alleging violation of those two acts are substantially less prominent than those alleging viola-
tion of the 1933 Act or the 1934 Act.

Even though the SEC had been considering a safe harbor for years, it considered the adoption of the
Safe Harbor to be an experiment, whose results would be reviewed as experience under the Safe Harbor yield-
bor does not apply to a claim will nevertheless have to meet the other elements of the cause of action.31

Second, the Safe Harbor as originally proposed was limited to financial items; it did not apply to a management’s statements concerning future economic performance or plans and objectives. In its publication of proposed Division of Corporation Finance guides for projections in 1976, the SEC expressed its concern that disclosure of projected revenues without an accompanying projection of net income might be misleading.32
The expansion of the Safe Harbor in the adopting release to include other items, such as capital expenditures and statements of objectives,33 without requiring disclosure of projections for specified financial items, reflects certain conclusions. Those conclusions include an acknowledgement that analysts and others evaluating a reporting company’s financial position and prospects might find useful detailed forward-looking information relating to discrete aspects of the company as well as broad objectives, even if complete projections are not disseminated (whether because they are not available or because the reporting company declines to make them available).34 A company releasing incomplete forward-looking information within the Safe Harbor would nevertheless be subject to the requirement that the disclosure, as a whole, not be false or misleading.35

Third, as originally proposed, the Safe Harbor placed on the issuer the burden of proving the projection was prepared in good faith and with a reasonable basis. This position was premised on a belief that plaintiffs would find a requirement that they prove absence of a reasonable basis for the projections an “insurmountable” hurdle.36
The SEC placed the burden of proof on plaintiffs when it adopted the Safe Harbor. The SEC was persuaded by comments arguing that liberal discovery procedures afforded plaintiffs an adequate ability to meet the burden.37 Thus, the burden of proof was placed on plaintiffs in reliance on the understanding that plaintiffs would be able to use the results of discovery to meet this burden.

Fourth, the Safe Harbor as adopted encompasses disclosure of assumptions underlying forward-looking disclosure, although the terms of the Safe Harbor do not require disclosure of the underlying assumptions. However, the SEC noted that the assumptions may be an important factor in evaluating forward-looking statements, and in certain cases their disclosure may be necessary for the forward-looking statements not to be misleading.38

31. See Securities Act Release No. 6084, 44 Fed. Reg. at 38,811 n.9 (“If a plaintiff seeking to establish liability on the basis of a forward looking statement can make such a showing, he and the defendant must still meet whatever standards are applicable in the circumstances of the particular claim and the relief sought. See, e.g., sections 12 and 17 of the Securities Act and sections 10, 18 and 20 of the Exchange Act.”) (citations omitted).
34. A reporting company releasing certain forward-looking information might decline to issue complete forward-looking statements that are available for bona fide reasons, such as concerns of premature disclosure to competitors. See, e.g., Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 514-15 (7th Cir. 1989).
35. See Securities Act Release No. 5992, 43 Fed. Reg. at 53,248 n.20 (“However, selective projection of only favorable items may create misleading inferences . . . .”).
37. Id.
38. Id. at 38,812; accord Isquith v. Middle S. Utils., 847 F.2d 186, 205 n.13 (5th Cir.), cert. denied, 488
Fifth, the Safe Harbor applies only to statements made in a document filed with the SEC or reaffirmed in a document filed with the SEC within a reasonable time. This requirement reflects the SEC’s concern that information not required to be disclosed may nevertheless be important to those investing in securities. Therefore, to encourage companies to disseminate widely any forward-looking information they release, application of the Safe Harbor is conditioned on the statements being made in documents available to the public through the SEC.

II. DEVELOPMENT OF THE BESPEAKS CAUTION DOCTRINE IN THE COURTS OF APPEALS

The Bespeaks Caution Doctrine had its origins in a footnote in Pollin v. Conductron Corporation. Pollin involved a shareholder suit alleging that the issuer’s annual reports for 1965 through 1968 and its proxy statement for a 1966 acquisition were false and misleading. The plaintiff sought relief under section 10(b) of the 1934 Act and Rule 10b-5. Conductron acquired the business of McDonnell Aircraft Corp.’s Electronic Equipment Division, which included the design and manufacture of aircraft simulators. The proxy statement sent to Conductron’s shareholders in respect of the acquisition noted that the Division had recently been awarded contracts to build three simulators for a particular series of aircraft, and that “[e]xpected additional contracts for [simulators for that series of aircraft] will be necessary to recover development and other start up costs.” After the acquisition, Conductron’s Annual Reports became progressively more pessimistic as to the company’s prospects, and included write-offs of development costs for these simulators. The plaintiff claimed these reports had failed to report promptly the anticipated losses and that write-offs of the associated assets were thus improperly delayed. In affirming the district court's judgment for the defendants after a bench trial, the court of appeals stated:

Likewise, fraud is charged with respect to the 1967 Annual Report on the ground that “anticipated” losses had not, as the report stated, been charged off, and, further, that the report stated that the results for 1968 were “expected” to show improvement, and the Company saw a “possibility” of a break-even soon. The terms thus employed bespeak caution in outlook and fall far short of the assurances required for a finding of falsity and fraud. Language of expectation, of anticipation, and of possibilities recognizes the


41. 552 F.2d 797, 806 n.28 (8th Cir.), cert. denied, 434 U.S. 857 (1977).

42. Although the complaint alleged violations of both §§ 10(b) and 14(a) of the 1934 Act, 15 U.S.C. § 78n(a), on appeal plaintiff relied solely on § 10(b) and Rule 10b-5. Pollin, 552 F.2d at 801 n.5.

43. Id. at 800, 803-04.

44. Id. at 805.

45. Id. at 806-07.

46. Id.
imponderable influences of complex variables in a fast-changing field.\textsuperscript{47}

In reaching this conclusion, the court of appeals held that there was no clear error of fact in the district court's finding that "there is no substantial basis for the contention that any of the reports withheld material information or fraudulently minimized losses which should have been anticipated."\textsuperscript{48}

There are two important aspects of the context in which the court of appeals stated that disclosure language bespeaking caution cannot underlie an action alleging falsity and fraud. First, at the time \textit{Pollin} was decided, the Supreme Court had recently held in \textit{Ernst & Ernst v. Hochfelder}\textsuperscript{49} that scienter—intent to deceive, manipulate or defraud—was a required element of any private action under Rule 10b-5.\textsuperscript{50} In \textit{Ernst & Ernst}, the Court expressly deferred consideration of whether recklessness would be sufficient to constitute scienter for a private action under Rule 10b-5.\textsuperscript{51} However, the \textit{Pollin} court's citation of \textit{Ernst & Ernst} makes no reference to the possibility that recklessness may be sufficient to constitute scienter for purposes of liability under Rule 10b-5.\textsuperscript{52} The opinion notes that allegations of negligence would not be a sufficient basis for claims under Rule 10b-5; rather, allegations of intent to deceive, manipulate or defraud were required.\textsuperscript{53} Thus, the language in \textit{Pollin} quoted above may merely be a reflection of that court's failure to recognize that recklessness is sufficient to constitute scienter, which is today supported by the weight of authority.\textsuperscript{54}

Second, the procedural posture of the case is significant. The court's holding that terms bespeaking caution could not be the basis for an action under Rule 10b-5 was in the context of a finding that no material information was omitted from the relevant disclosure documents and the losses were not fraudulently minimized. Therefore, to apply this doctrine to motions under Federal Rule of Civil Procedure 12(b)(6), with respect to claims under Rule 10b-5 where scienter has been adequately pled, requires an extension of \textit{Pollin}. It would be consistent with \textit{Pollin} for a court to hold that misleading statements bespeaking caution are actionable under Rule 10b-5 if there is adequate factual support for an allegation that the statements were made with reckless disregard of their falsity.

Relying on the principles of \textit{Pollin}, the Courts of Appeals for the First, Second, Third, Fifth, Sixth, and Eighth Circuits have declined to find liability under Rule 10b-5 or section 11 of the 1933 Act for statements that bespeak caution. The Court of Appeals for the Ninth Circuit has held that statements accompanied by similar disclaimers cannot form the basis of a cause of action under section 11 of the 1933 Act and Rule 10b-5. The Court of Appeals for the Seventh Circuit has declined to apply the Bespeaks Caution Doctrine where the Safe Harbor was applicable. Some of these opinions have extended the scope of the protection in some circuits to (i) cases in which recklessness

\textsuperscript{47} \textit{Id.} at 806 n.28.
\textsuperscript{48} \textit{Id.} at 807.
\textsuperscript{49} 425 U.S. 185 (1976).
\textsuperscript{50} \textit{Id.} at 193.
\textsuperscript{51} \textit{Id.} at 193 n.12.
\textsuperscript{52} \textit{Pollin}, 552 F.2d at 807 n.33.
\textsuperscript{53} \textit{Id.}
\textsuperscript{54} \textit{See supra} note 15 and accompanying text.
The Bespeaks Caution Doctrine (as opposed to intentional fraud) is the express basis of the claim, (ii) cases in which a determination is made solely on the pleadings, and (iii) cases in which the allegedly fraudulent statements are increasingly precise. Other circuits have taken a more restrictive view, with cautionary language merely a factor weighed in determining whether a statement is false or misleading. The remainder of this Part II reviews those cases chronologically in the order that the respective circuits first addressed the issue.

A. Second Circuit

The Court of Appeals for the Second Circuit relied on this aspect of Pollin in Goldman v. Belden.55 Goldman involved a class action alleging that Sykes Datatronics, Inc., a reporting company,56 and certain of its officers had "disseminated very positive forecasts about its operations which were materially misleading."57 In 1982 Sykes had two principal product lines, one of which was introduced that year.58 The statements in question included, among others: (i) language in the letter to shareholders included in Sykes' 1982 Annual Report that fiscal year 1983 was expected to be a year of strong growth in sales and earnings; (ii) remarks at the annual shareholders meeting, subsequently disseminated to the public, that although Sykes had experienced some competition with respect to the newly-introduced product line, Sykes expected to be the dominant supplier in the market and was "geared up to do a lot more business than [it did] last year. And [it was] going to be doing it" and that Sykes was aiming for "40 or 50% [growth], or better"; and (iii) a reiteration in the Quarterly Report on Form 10-Q for the first quarter of 1983 that the outlook for growth for fiscal 1983 remained good.59

In holding that the complaint adequately stated a claim with respect to those statements, the court of appeals stated:

The district court's conclusion that the Complaint failed to state a claim because it attacked defendants' "failure to perceive," and therefore faulted them merely for failing to make accurate predictions, also viewed the Complaint unduly narrowly. While it is true that not all predictions are actionable and that liability probably should not be imposed on the basis of words that "bespeak caution," the claim here is that there was no note of caution in the defendants' statements and that defendants knew caution was warranted. The Complaint alleged that defendants made a series of very positive

55. 754 F.2d 1059 (2d Cir. 1985).
56. The phrase "reporting company" refers to a company required to file periodic reports with the SEC pursuant to section 13 of the 1934 Act, 15 U.S.C. § 78m (1988), by virtue of having a class of securities registered under § 12(b) or § 12(g) of the 1934 Act, 15 U.S.C. §§ 78(b), (g) (1988), or by virtue of § 15(d) of the 1934 Act, 15 U.S.C. § 78o(d) (1988), as a result of having sold securities in a registered offering. Section 12(b) provides for registration under the 1934 Act of a class of securities registered on a national securities exchange, either debt or equity, whereas § 12(g) relates to equity securities held of record by 500 persons or more issued by companies with more than $1 million in total assets. The SEC has exempted from the registration requirements of § 12(g) companies with total assets not exceeding $5 million (as long as, in the case of a non-U.S. private issuer, the securities also are not quoted on an inter-dealer quotation system). 17 C.F.R. § 240.12g-1 (1993).
57. Goldman, 754 F.2d at 1062 (summarizing the complaint).
58. Id.
59. Id. (quoting in part the complaint).
predictions as to the probable success of [the new product line] without qualifications, while they knew of the infirmity of the Company's reliance on [a particular customer] and knew of many flaws in [the new product line] . . . .

Applicability of the Safe Harbor to projections does not require that the projections be accompanied by language reinforcing that the projections are estimates (and not certain to occur). Inherent in that approach is a belief that individuals receiving projections will understand that they represent estimates. However, the court did not consider this line of analysis or try to harmonize its analysis with the Safe Harbor. Moreover, an annual meeting, where the quantitative comments were made, is not a context that facilitates dissemination of disclaimers emphasizing that growth goals are not certain to be met. Nevertheless, the court pointed to the absence of a cautionary tone in holding that the complaint adequately stated a claim under section 10(b) of the 1934 Act, suggesting that had such disclaimers been included, the statements would not have been actionable.

In Luce v. Edelstein, the Court of Appeals for the Second Circuit addressed, among other claims under section 10(b) of the 1934 Act, a claim that an offering memorandum contained intentional misrepresentations concerning the potential cash and tax benefits of investing in a partnership that would renovate buildings and convert them into condominium units. The district court had dismissed the claims under section 10(b) for failure to plead fraud with particularity under Federal Rule of Civil Procedure 9(b) and denied leave to amend the complaint. The court of appeals reversed the denial of leave to amend the complaint and, as to certain claims, reversed the holding that the plaintiffs had not pled fraud with particularity. Turning to the merits of claims under section 10(b) that the offering memorandum contained intentional misrepresentations as to potential cash flow and tax benefits, the court stated:

However, the Offering Memorandum made it quite clear that its projections of potential cash and tax benefits were "necessarily speculative in nature" and that "[n]o assurance [could] be given that these projections [would] be realized." Indeed, the Offering Memorandum warned prospective investors that "[a]ctual results may vary from the predictions and these variations may be material." We are not inclined to impose liability on the basis of statements that clearly "bespeak caution." Again, the court did not consider the framework of the Safe Harbor in determining the scope of the Bespeaks Caution Doctrine. The language of this holding represents an extreme position—that disclosure noting that the projections are speculative can prevent

60. Id. at 1068 (citations omitted).
61. The Safe Harbor did not apply to all these statements, as some were not filed with the SEC.
62. The court did not refer to the Safe Harbor.
63. 802 F.2d 49 (2d Cir. 1986).
64. Id. at 52, 56.
65. Id. at 51. See part III of this Article for a discussion of the application of Federal Rule of Civil Procedure 9(b) to federal securities laws claims.
66. Luce, 802 F.2d at 56.
67. Because the offering was not registered, id. at 52, the Safe Harbor did not apply.
The Bespeaks Caution Doctrine

liability under Rule 10b-5 even if the projections are misleading and were prepared with scienter.

The Second Circuit subsequently extended the bespeaks caution doctrine to cases alleging violation of section 11 in *I. Meyer Pincus & Associates v. Oppenheimer & Co.*,68 which concerned the offering of shares in a closed-end investment company.69 In that case, the plaintiff alleged, among other claims, that a statement in the summary of the prospectus that "shares of closed-end investment companies frequently trade at a discount from or premium to their net asset values" was misleading because such shares generally trade at a discount, although they occasionally trade at a premium.70 The court, citing *Luce*, held that the statement was not actionable because it was followed71 by a statement that the issuer could not predict whether the shares would trade at a discount or a premium. The court also focused on a cross-reference to another section of the prospectus that stated that shares "frequently trade at a discount from net asset value, but in some cases trade at a premium."72

The better reading of *Pincus* is that the more prominent statement was not misleading because it was literally correct and any omission was cured by the prominent cross-reference to the more accurate information. Alternatively, one could read *Pincus* as supporting the proposition that (i) the relevant consideration for a purchaser of the securities in question was whether they would trade, in the future, at a discount to or premium over net asset value and (ii) the language stating that no prediction was made as to the future trading prices insulated the issuer from liability for misstatements of material73 historical information that was not issuer-specific74 but could nevertheless

68. 936 F.2d 759 (2d Cir. 1991).
69. Id. at 762-63.
70. Id. at 762.
71. The court noted that disclosure may be actionable if it is not sufficiently prominent. Id. (quoting *Greenapple v. Detroit Edison Co.*, 618 F.2d 198, 210 (2d Cir. 1980)). The court also gave weight to the statement in the prospectus summary that the statements in that part of the prospectus were qualified by the "more detailed information" included in the remainder of the document, even though the other information was different but not materially more detailed (only three words longer). *Pincus*, 936 F.2d at 762-63. See generally *Isquith v. Middle S. Utils., Inc.*, 847 F.2d 186, 202 (5th Cir.) ("Adequacy of disclosure is a function of position, emphasis, and the reasonable expectation that certain future events will occur.") (quoting *Smallwood v. Pearl Brewing Co.*, 489 F.2d 198 (5th Cir. 1974)), cert. denied, 488 U.S. 926 (1988); Rule 421(a) under the 1933 Act, 17 C.F.R. § 230.421(a) (1993) ("[I]nformation shall not, however, be set forth in such fashion as to obscure any of the required information or any information necessary to keep the required information from being incomplete or misleading."); Rule 411(a) under the 1933 Act, 17 C.F.R. § 230.411(a) (1993) ("Where a summary or outline of the provisions of any document is required in the prospectus, the summary or outline may incorporate by reference particular items, sections or paragraphs of any exhibit and may be qualified in its entirety by such reference."). *See also* *Eckstein v. Balcor Film Investors*, 8 F.3d 1120, 1131 (7th Cir. 1993) ("[I]n the event statements in sales brochures and the prospectus do not agree, the prospectus wins."). Since an issuer can eliminate any conflict without incurring any cost (other than the loss of profit from sales to deceived investors), it is curious that, under *Eckstein*, an issuer can create an unnecessary conflict and profit thereby.
72. *Pincus*, 936 F.2d at 762-63. The district court had dismissed the complaint for failure to plead fraud with particularity. Id. at 761.
73. *Cf. Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 282 (3d Cir.) ("By addressing the quality of a particular management practice, a defendant declares the subject of its representation to be material to the reasonable shareholder, and thus is bound to speak truthfully."). cert. denied, 113 S. Ct. 365 (1992); accord *In re Wells
be an important factor in a purchaser's analysis of the likelihood that the securities would trade at a discount to net asset value.

The court failed to address the rationale for extending the Bespeaks Caution Doctrine to claims alleging violation of section 11 of the 1933 Act, which do not include scienter as an element of the claim.

B. Fifth Circuit

The Court of Appeals for the Fifth Circuit more narrowly interpreted the import of the Bespeaks Caution Doctrine in *Isquith v. Middle South Utilities, Inc.* The Fifth Circuit vacated the district court's grant of summary judgment for the defendant as to claims alleging that forward-looking statements concerning, among other matters, anticipated costs and completion dates for nuclear power plants violated section 10(b) of the 1934 Act and section 11 of the 1933 Act. The court stated that estimates can be actionable under the federal securities laws. Whether they are actionable depends on the nature of the predictions. The court noted:

Most often, whether liability is imposed depends on whether the predictive


74. Cases have not settled the extent to which the federal securities laws require companies to disclose in documents required to be filed with the SEC information that is not company-specific. Compare *Raab v. General Physics Corp.*, 4 F.3d 286, 290-91 (4th Cir. 1993) (holding that the issuer had no duty to disclose that the end of the Cold War might affect the issuer's defense-related business, because that possibility was commonly known) and *Sailor v. Northern States Power Co.*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,724, at 97,424 (8th Cir. Sept. 2, 1993) (stating with respect to a utility's failure to disclose information that a reasonable investor allegedly would have found helpful in evaluating the likelihood that a requested rate increase would have been approved, "[O]nce a utility has informed investors that it is involved in a regulatory proceeding, it has no affirmative duty to provide investors with a further summary of the regulatory process.") and *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 515 (7th Cir. 1989) ("Securities laws require issuers to disclose *firm-specific* information.") and *Acme Propane, Inc. v. Tenexco, Inc.*, 844 F.2d 1317, 1323-24 (7th Cir. 1988) ("The securities laws require the disclosure of information that is otherwise not in the public domain. Sellers of securities need not 'disclose' the statutes at large of the states in which they operate, any more than they have to disclose how the acquisition of oil for the Strategic Petroleum Reserve may affect the value of a 2% share of an oil well.") (citation omitted) and *Morgan Stanley & Co. v. Archer Daniels Midland Co.*, 570 F. Supp. 1529, 1542-43 (S.D.N.Y. 1983) (denying the plaintiff-bondholders' motion for summary judgment on a claim under Rule 10b-5 that the issuer improperly failed to disclose that covenants, which restricted the redemption of the bonds with the proceeds of indebtedness bearing a lower rate of interest, did not prevent certain refinancing transactions and therefore provided less protection than was obvious from their terms) with *McMahan & Co. v. Wherehouse Entertainment, Inc.*, 900 F.2d 576, 580 (2d Cir. 1990) (stating that a factually accurate description of a put right in a debenture indenture that was triggered by certain events unless approved by the "Independent Directors" could be found by a jury to be misleading where there were a number of omissions, including the omission of the statement that "Independent Directors" had no fiduciary duty to debenture holders), *cert. denied*, 111 S. Ct. 2887 (1991) and *Item 101(c)(1)(x), Regulation S-K, 17 C.F.R. § 229.101(c)(1)(x) (1993) (requiring disclosure of competitive conditions in the business involved including, where material, an estimate of the number of competitors and the registrant's competitive position and identification of the competitors who dominate the industry if they are a small number and known). The significant question is not whether companies are required to disclose information known to the general public, but rather whether companies are required to apply that public information to describe the implications of that information for their security holders, which may be less obvious.

75. 847 F.2d 186 (5th Cir. 1988).

76. *Id.* at 203-04.
The Bespeaks Caution Doctrine

statement was "false" when it was made. The answer to this inquiry, however, does not turn on whether the prediction in fact proved to be wrong; instead, falsity is determined by examining the nature of the prediction—with the emphasis on whether the prediction suggested reliability, bespoke caution, was made in good faith, or had a sound factual or historical basis.77

Unlike the court in Luce, the court in Isquith did not hold that statements that "bespoke caution," by that fact alone, were not materially false or misleading. Rather, the extent to which the language of an estimate suggested reliability or was cautious was a factor in determining whether the statement was materially false or misleading. The Luce court did not express a distinction between claims under Rule 10b-5 and those under section 11 of the 1933 Act. However, the context of some statements bespeaking caution might evidence negligence (which would satisfy section 11) but not reckless disregard of the truth of the matter addressed (required for claims under Rule 10b-5).

In Krim v. BancTexas Group, Inc.,78 the plaintiffs sought relief under both section 11 of the 1933 Act and Rule 10b-5 for statements in a prospectus that the issuer was "hopeful" that a contemplated restructuring would resolve its financial problems.79 As to the plaintiffs' claim that the statements were misleading because they were made without any factual basis, the court stated, "[s]imilarly, projections of future performance not worded as guarantees are generally not actionable under the federal securities laws."80 This language continues the Fifth Circuit's concentration on the nature of the language used, suggesting that the statement of hope would not be actionable even if there were no reasonable basis for the belief. However, that issue was not expressly addressed, because the plaintiff was unable to present any evidence supporting the allegation.81

C. First Circuit

In Romani v. Shearson Lehman Hutton,82 the court addressed claims under Rule 10b-5 that predictions in a prospectus for interests in a partnership engaged in standardbred horsebreeding were false or misleading. The horsebreeding industry was entering a recessionary period at the time the interests were offered, although the predictions included in the prospectus were largely based on historical results that allegedly had occurred in a dramatically more favorable market.83

The First Circuit affirmed the district court's dismissal of the complaint as to most of the claims for failure to allege fraud with specificity. The plaintiff claimed that inclu-

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77. Id. (citations omitted).
78. 989 F.2d 1435 (5th Cir. 1993) (reviewing a grant of summary judgment after limited discovery).
79. Id. at 1447.
80. Id. at 1446 (citations omitted). This language was quoted with approval in Shushany v. Allwaste, Inc., 992 F.2d 517, 524 (5th Cir. 1993) (basing its decision, in part, on Federal Rule of Civil Procedure 9(b)).
81. Id., 989 F.2d at 1447. As to this claim, the court also made no distinction between causes of action under § 11 and Rule 10b-5, which were both alleged, although the separate elements were identified. Id. at 1445, 1446 n.11.
82. 929 F.2d 875 (1st Cir. 1991).
83. Id. at 877.
sion of optimistic projections based on historical results was misleading when the prospectus did not indicate that the industry was entering a recession. The court stated that this particular omission could not form the basis of a federal securities law claim as a matter of law because: (i) the prospectus included detailed information concerning specific problems facing the industry; and (ii) the prospectus included numerous statements emphasizing the high risks of an investment, including one statement that it was "impossible to predict with any certainty the future economic trend of the Standardbred industry as a whole." The court did not rely on or refer to the Safe Harbor, even though the projections were included in a registration statement.

Romani's reach may be limited. It is difficult to demonstrate that an issuer has acted recklessly in preparing projections based on historical information. That conclusion would be even more difficult to support where the historical information becomes unrepresentative of the future near the time the projections are released.

D. Ninth Circuit

In re Convergent Technologies Securities Litigation presented the Ninth Circuit with claims asserting causes of action under both section 10(b) of the 1934 Act and section 11 of the 1933 Act for cautionary disclosure of opinions. In 1982, Convergent began finalizing development plans for a new product line to replace its first product, a computer workstation, which had been first shipped in 1981. In a prospectus dated March 17, 1983, Convergent disclosed that it was developing the new product line and was anticipating that it would provide significant performance and price advantages over the first product line. The prospectus also stated, "[W]hile the Company believes that the technical risks in the development of these products are well controlled, the product cost objectives are very aggressive, and there is no assurance that they can be achieved." This negative disclosure was repeated in a prospectus issued in August 1983, which also stated that the risks of the new product line related to completion of the new product line within its specifications and the availability of components.

However, certain negative information was not set forth in these prospectuses. For example, in February, the project director for the new line noted that "the cost/pricing structure for [the new product line] would leave the company 'with no profit'" and that "he did not yet 'know how to achieve' the necessary reductions." In late March, he circulated a memorandum, which noted that in a best-case scenario, all sales of the new product to a major customer would be at a negative gross margin (i.e., direct cost of goods sold, without fixed costs, would exceed revenues for the line) through 1983.

84. Id. at 879.
85. Id. at 876.
86. 948 F.2d 507 (9th Cir. 1991) (reviewing the district court's grant of summary judgment in favor of the defendants on all claims).
87. Id. at 509-10.
88. Id. at 510.
89. Id. at 510, 515-16.
90. Id. at 510 (summarizing in part, and quoting in part, an internal memorandum).
91. The customer accounted for approximately one-half of Convergent's total sales. Id. at 512.
92. Id. at 510 & n.1.
Shortly after the August offering, internal studies confirmed that most configurations of the new product line were being sold at negative gross margins, and certain configurations were expected to remain at a negative gross margin through at least the second quarter of 1984.\textsuperscript{93}

The court held that the disclosure concerning profitability of the new product line was adequate, affirming the district court's dismissal of claims relating to the failure to disclose this negative information. The court stated, "Clearly, Convergent’s disclosures warned investors that problems with attaining internal cost objectives could impact the ultimate profitability of [the new line]."\textsuperscript{94} The court also stated that Convergent was not obligated to disclose the internal statements concerning the profitability of the line, quoting a case questioning whether particular projections based on questionable assumptions could be publicly disclosed and noting that Instruction 7 to Item 303(a) of Regulation S-K\textsuperscript{95} does not require disclosure of forward-looking information.\textsuperscript{96}

Two aspects of this opinion deserve emphasis. First, the court did not articulate any distinction between events that may or may not occur in the future and facts presently known that are likely to have some effect in the future (even if the magnitude of that effect is presently unknown).\textsuperscript{97} For example, as of February, Convergent’s pricing structure would not result in profitable sales of the new product line, and only with anticipated future cost-cutting would these sales become profitable. However, the court held that these facts did not have to be disclosed. Second, the case supports the proposition that disclosure need only identify future risks (and state that there can be no assurance that they won't occur), with articulation of presently known facts facilitating analysis of the likelihood of the risks not being required.\textsuperscript{98}

\textsuperscript{93} Id. at 510-11.
\textsuperscript{94} Id. at 515.
\textsuperscript{95} 17 C.F.R. § 229.303(a).
\textsuperscript{96} Convergent Technologies, 948 F.2d at 516.
\textsuperscript{97} The SEC in 1989 addressed this distinction with great insight. Management’s Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 6835, 43 SEC Docket (CCH) 1330, 1333 (May 18, 1989). The SEC stated in that release:

The Project results confirm that the distinction between prospective information that is required to be discussed and voluntary forward-looking disclosure is an area requiring additional attention. This critical distinction is explained in the Concept Release:

Both required disclosure regarding the future impact of presently known trends, events or uncertainties and optional forward-looking information may involve some prediction or projection. The distinction between the two rests with the nature of the prediction required. Required disclosure is based on \textit{currently known trends, events, and uncertainties that are reasonably expected to have material effects}, such as: A reduction in the registrant’s product prices; erosion in the registrant’s market share; changes in insurance coverage; or the likely non-renewal of a material contract. In contrast, optional forward-looking disclosure involves \textit{anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty}.

\textsuperscript{98} This type of disclosure is likely to be used by companies that have identified a problem that they would prefer not to disclose. Another example of that disclosure was identified in Brown v. E.F. Hutton Group, Inc., 735 F. Supp. 1196 (S.D.N.Y. 1990). In that case, the court held that the identification of risks, including the statement that "[i]n the event that oil and gas prices fall or do not rise, profit potential may be limited," adequately warned investors who alleged that those prices needed to rise 33% in order for a repur-
In re VeriFone Securities Litigation\textsuperscript{99} concerned allegations similar to those addressed in Convergent Technologies. The plaintiffs alleged, inter alia, that a prospectus was materially misleading, because it omitted that the company’s sales growth in its core market segment had slowed substantially, its historical sales channels were showing little growth potential and the company was thus forced to market its products in new markets, in which the company’s sales force had little experience and was meeting substantial resistance.\textsuperscript{100} The plaintiffs also alleged that the first Quarterly Report on Form 10-Q filed after the offering failed to disclose that the quarterly sales included large "one-time" sales, which would not recur.\textsuperscript{101} The court characterized these allegations as requiring the company to make forecasts and affirmed the district court’s dismissal of the complaint under Federal Rules of Civil Procedure 9(b) and 12(b)(6) on the basis that companies are not required to make forecasts.\textsuperscript{102} The court also stated, "While [17 C.F.R. § 229.303(a)(3)(ii) provides that ‘known trends or uncertainties’ be disclosed in certain SEC filings, another SEC regulation, which expressly addresses forecasts, states that forward-looking information need not be disclosed. 17 C.F.R. § 229.303(a), Instruction 7.\textsuperscript{103}"

The dissent recognized that the essence of the claims was that factual information known at the time of the offering was not disclosed.\textsuperscript{104} Although many of the paragraphs of the complaint that set forth the alleged omissions were phrased in the future tense,\textsuperscript{105} the claims concerning selling products in new markets addressed information that did not involve any prediction or subjective judgment. At the time of the offering, the registrant allegedly was implementing a plan to sell in new markets and was experiencing difficulty. Similarly, disclosure that certain sales were one-time does not inher-
ently involve a prediction of the future. In various circumstances, the nature of a purchaser's demand for a product, e.g., extraordinary capital expenditures that are large in comparison to prior sales to that customer, or statements made by the purchaser indicate that the purchase will satisfy the particular customer's requirements for a substantial length of time. It is such a deviation from historical sales to a particular customer that should have been disclosed. For example, disclosure could take the form that (x) a specified percentage of the quarter's sales were to one customer, representing a specified increase over the average quarterly sales to that customer and (y) those sales were not made pursuant to a long-term contract. That disclosure does not require a prediction. These items are precisely the type of present trends that should be disclosed and whose omission should be actionable.106

*In re Worlds of Wonder Securities Litigation*107 presented an extreme application of the Bespeaks Caution Doctrine by a district court in the Ninth Circuit. The court held that the statement in a prospectus "that 'there can be no assurances' that [the registrant's] existing internal controls would continue to be adequate given the rapid pace at which the company was growing," was adequate to disclose that the internal controls were "facing serious problems."108 The disclosure provided no information permitting analysis of the risk, and therefore should not have been adequate. The court also held that the registrant need not have disclosed a policy of crediting each customer's account for subsequent decreases in the sales prices of the goods. The opinion does not explain the scope of the policy (for example, how long it applied to each sale), but the policy resulted in an adjustment equal to 28% of the prior year's sales.109 The court stated that the policy "did not pose a foreseeable risk to [the registrant's] investors," because there was no evidence as of the date of the prospectus that "[the registrant's] management could have foreseen that [the registrant] would have to reduce its prices to such an extent."110

That analysis is not appropriate. Where a company assumes a substantial risk, its obligation to disclose that fact should not be postponed until the adverse event occurs. The structure of the regulatory scheme embodied in Regulation S-K supports the conclusion that disclosure was required. Item 101 of Regulation S-K expressly requires disclosure of dependence on a single customer111 and the following:

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106. Cf. Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 6835, 43 SEC Docket (CCH) 1330, 1334 (May 18, 1989) (citing reporting companies that had failed to disclose that their accounting methods would favorably affect present results while adversely affecting future periods). In Raab v. General Physics Corp., 4 F.3d 286, 290 (4th Cir. 1993), the court, relying on Virginia Bankshares v. Sandberg, 111 S. Ct. 2749 (1991), distinguished estimates of present value from predictions of future growth, suggesting that the latter may rarely, or never, be actionable. This distinction is curious, particularly if one considers that estimates of present value may be derived by capitalizing anticipated revenues, i.e. multiplying anticipated revenues by the reciprocal of an assumed discount rate. See, e.g., *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 373 n.17 (3d Cir. 1993) (considering an appraisal of a hotel/casino that used the capitalization of income method).


108. Id. at 865 (quoting in part and paraphrasing in part the prospectus).

109. See id. at 854, 865.

110. Id. at 865.

practices of the registrant and the industry (respective industries) relating to working capital items (e.g., where the registrant is required to carry significant amounts of inventory to meet rapid delivery requirements of customers . . . ; where the registrant provides rights to return merchandise; or where the registrant has provided extended payment terms to customers). 112

These requirements reflect a recognition that disclosure of risks assumed is not dependent on the contingency having first occurred before the risks are required to be disclosed.

E. Sixth Circuit

The Sixth Circuit considered liability under the federal securities laws for predictions that bespeak caution in Sinay v. Lamson & Sessions Co. 113 Sinay involved a reporting company in the business of manufacturing construction and transportation equipment products, which had "disclosed that its performance during the first three quarters was 'gratifying,' although it was experiencing a 'normal seasonal decline' in its commercial and residential markets which would last 'into the first quarter of 1989.'" 114 The company subsequently released similar positive statements. Then, in an interview, the company's CEO stated that the company "does not quarrel with analysts' earnings estimates for 1989 in the area of $1.50 to $1.60" but that the company was "counting on new products to offset a weaker construction market for 1989." The CEO also indicated that there was a lower demand for construction products due to higher interest rates and that the company's sales in a particular line might decrease if interest rates did not decline even if unit sales volume remained constant. 115 The court noted that the plaintiffs offered no objective evidence that the statements were not made in good faith based on historical information, stated that "[e]conomic projections are not actionable if they bespeak caution," and held that the cautionary language was sufficient to warn an investor that the company's future was uncertain. 116

Regarding claims concerning the analysts' estimates, Sinay is a model of the circumstances in which the Bespeaks Caution Doctrine should be applied if the doctrine is to be followed at all. First, the reporting company's CEO did not originate the earnings estimates; he was asked to address estimates made by others. Second, the CEO did not


There is a presumption that items required to be disclosed by a schedule promulgated by the SEC are material. Howing Co. v. Nationwide Corp., 972 F.2d 700, 703-04 (6th Cir. 1992) (considering Schedule 13E-3, 17 C.F.R. § 240.13e-100), cert. denied, 113 S. Ct. 1645 (1993).

113. 948 F.2d 1037 (6th Cir. 1991).

114. Id. at 1039.

115. Id. at 1039-40.

116. Id. at 1040-41.
unambiguously adopt the analysts' estimates; rather, he said that he did not "quarrel" with estimates in a certain range, indicating that the estimate may not be precise.\textsuperscript{117} Third, the statement about earnings for 1989 was accompanied by the identification of certain general economic factors that would adversely affect the ability of the company to meet these targets and related them to particular aspects of the company's business. Fourth, no objective evidence was offered to show that the statements were made in bad faith or not based on historical information. Fifth, these statements would have fallen within the Safe Harbor if the earnings estimates had been made in documents filed with the SEC. In fact, the Safe Harbor would apply to earnings projections phrased in much less cautionary language and not accompanied by the identification of factors that may prevent realization of the estimates. Sixth, as the plaintiff alleged violation of section 10(b) of the 1934 Act, scienter was a necessary element of the claim.

The Court of Appeals for the Sixth Circuit revisited the holding of \textit{Sinay} in \textit{Mayer v. Mylod},\textsuperscript{118} in the context of alleged misstatements arising from decreasing real estate values and a lender's corresponding increasing exposure under loans secured by real estate. In \textit{Mayer v. Mylod}, the court summarized the plaintiffs' allegations as follows:

Michigan National stated that it intended to have strong financial controls, intended to strengthen its balance sheet, had no non-performing real-estate loans, and had implemented a program to improve the quality of its operations; Michigan National stated that its loan portfolio was "soundly underwritten" and its value was "fairly reflected on the balance sheet;" . . . and Michigan National, in response to a fifty percent decline in the price of its stock, stated that its non-performing loans did not warrant the decline in share prices.\textsuperscript{119}

The complaint alleged:

\textit{[D]efendants misrepresented and concealed the deteriorated quality of Michigan National's loan portfolio, intentionally concealed and misrepresented the likelihood of huge increases in non-performing assets, charge-offs and loss reserves, and failed to set appropriate loan loss reserve levels on commercial real estate loans. Michigan National's net income, assets and net worth were materially overstated as a result, and the market prices of Michigan National's publicly-traded securities were artificially inflated . . . .}\textsuperscript{120}

The sole cautionary note in the disclosure identified in the court's opinion was the fact that the statements were the issuer's intentions and opinions. The court did not refer to any statements made by the issuer identifying factors that would affect the extent to which the forward-looking statements could be weighed or evaluated.


\textsuperscript{118} 988 F.2d 635 (6th Cir. 1993). The plaintiffs asserted claims under §§ 10(b) and 20(a) of the 1934 Act.

\textsuperscript{119} \textit{Id.} at 636-37.

\textsuperscript{120} \textit{Id.} at 637 (quoting the amended complaint).
In reversing the district court's dismissal of the complaint under Federal Rule of Civil Procedure 12(b)(6), the court reviewed the holding in *Virginia Bankshares v. Sandberg*¹ and stated:

The court in *Virginia Bankshares* noted, "publishing accurate facts in a proxy statement can render a misleading proposition too unimportant to ground liability," which is similar to the *Sinay* court's statement that predictions are not actionable if accompanied by words of caution. However, the court in *Virginia Bankshares* went on to say "But not every mixture with the true will neutralize the deceptive. If it would take a financial analyst to spot the tension between the one and the other, whatever is misleading will remain materially so, and liability should follow." Therefore, the central point of *Sinay*, that a claim is insufficient as a matter of law if optimistic opinions are coupled with cautionary statements, partially conflicts with *Virginia Bankshares* because *Virginia Bankshares* contemplates a weighing of the true with the untrue statements in an announcement for liability to result.

. . . For example, Michigan National's statement that the value of loans in Michigan National's portfolio is "fairly reflected on the balance sheet" is similar to the statement in *Virginia Bankshares* that $42 is a "fair price" for sale of certain stock.¹²²

*Mayer v. Mylod* and *Krim* are the first two court of appeals decisions addressing the Bespeaks Caution Doctrine that review the application of *Virginia Bankshares*' holding to the doctrine. The language in *Virginia Bankshares* quoted by the court was from the portion of the opinion addressing an argument that there should never be liability for an opinion if the factual basis for the opinion is disclosed.¹²³ *Virginia Bankshares* does not articulate a standard that the reporting company's disclosure must meet to avoid liability. The Court in *Virginia Bankshares* stated that disclosing accurate facts underlying an opinion could render a false or misleading opinion "too unimportant to ground liability," but that "[o]nly when the inconsistency would exhaust the misleading conclusion's capacity to influence the reasonable shareholder would a Section 14(a) action fail on the element of materiality."¹²⁴ The Court then found there was insufficient evidence to "compe[l] the jury to find the facial materiality of the misleading statement neutralized."¹²⁵

*Mayer* stands for the proposition that statements of opinion may be actionable under section 10(b) of the 1934 Act, and after *Mayer*, a false or misleading estimate or opinion will be actionable in the Sixth Circuit where any cautionary language accompanying the estimate or opinion does not clearly address the inaccurate aspect of the esti-

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¹²⁴. *Id.* The test of materiality under § 14(a) of the 1934 Act is the same as that under § 11 of the 1933 Act and Rule 10b-5. *See supra* note 17.
mate or opinion. However, the reference to Virginia Bankshares does not clarify what cautionary disclosure will suffice, because the statements made in Virginia Bankshares were allegedly made with knowledge of their falsity. The standard for language necessary to insulate an issuer from liability for estimates or opinions prepared negligently or recklessly may be lower than that required to neutralize intentional misstatements.

F. Eighth Circuit

The Eighth Circuit relied on the Bespeaks Caution Doctrine in affirming a district court's grant of summary judgment in Moorhead v. Merrill Lynch, Pierce, Fenner & Smith, Inc. In Moorhead, an accounting firm had been hired to review the financial feasibility of a new retirement center. The final report was attached to the offering memorandum for municipal bonds whose proceeds were to finance the construction. The plaintiffs alleged that the accounting firm prepared the study knowing the falsity of, or with reckless disregard for the validity of, its economic predictions and that the firm made misrepresentations and omitted material facts.

The study incorporated cautionary language, including the following: "[The accounting firm] believe[s] that the underlying assumptions provide a reasonable basis for management's forecast. However, some assumptions inevitably will not materialize . . .; therefore the actual results achieved during the forecast periods will vary from the forecast and the variations may be material." Additional cautionary language pointed to various factors as to which assumptions were made and stated that there could be no assurance that the levels of these factors assumed in making the forecast would be achieved. Although the memorandum summarized the assumptions made, there was no factual information that would permit a reader to assess independently the reasonableness of the assumptions, such as comparable information with respect to other retirement centers or any indication of the extent to which the projections were sensitive to changes in the assumptions.

As to the claims against the accounting firm, the court held, "We agree with the district court and hold that plaintiffs could not base a federal securities fraud claim on any misrepresentation or omission in the feasibility study which was addressed by the repeated, specific warnings of significant risk factors and the disclosures of underlying factual assumptions also contained therein." The district court had granted summary judgment for the defendant, concluding both (i) that there was no material misrepresentation in light of the cautionary language and (ii) that the plaintiffs failed to show that the defendants acted recklessly or with knowledge of falsity. The court of appeals based its holding on the disclaimers alone; it did not address the adequacy of any proof.

126. Id. at 2756.
127. 949 F.2d 243 (8th Cir. 1991).
128. Id. at 245.
129. Id. at 246 n.2.
130. Id. at 245.
131. Id. at 245-46.
132. Moorhead, 949 F.2d at 245.
of recklessness.\textsuperscript{133}

Along with \textit{Luce}, this case represents an extreme application of the doctrine. If use of certain assumptions is reckless, disclosure of the assumptions should not prevent liability where the error in the use of the assumptions is not obvious to individuals reviewing the estimates.

Although the case was decided four months after \textit{Virginia Bankshares}, it made no reference to \textit{Virginia Bankshares}, leaving uncertain whether that circuit's approach is affected by \textit{Virginia Bankshares}.

\textbf{G. Seventh Circuit}

The Seventh Circuit considered the Bespeaks Caution Doctrine in \textit{Roots Partnership v. Lands' End, Inc.}\textsuperscript{134} In that case, Lands' End had publicly stated on a number of occasions that its "goal" was to earn at least 10% net pre-tax profits over the next five years commencing with fiscal 1990, while the company had noted that its results in the current fiscal year (1990) would depend on its sales during the Christmas season.\textsuperscript{135} At the times when these statements were made, Lands' End's internal forecasts for its fiscal 1990 pre-tax profit percentage ranged from 9.38\% to 9.9\%.\textsuperscript{136} The court declined to hold that the statements of Lands' End's goal were not actionable under the Bespeaks Caution Doctrine, because "a reasonable investor could have taken them to imply that [Lands' End] had a reasonable basis for stating that Lands' End's earnings goal was attainable in fiscal 1990."\textsuperscript{137} The court distinguished \textit{Pollin} on the basis that \textit{Pollin}, unlike \textit{Lands' End}, decided materiality on the record and not as a matter of law. It distinguished \textit{Luce} because the projections in \textit{Luce} had been accompanied by disclaimers that the projections were "necessarily speculative" and that there was no assurance the projections could be realized, whereas Lands' End's statements "were not immaterial as a matter of law; instead they implied that defendants had a reasonable basis for stating that Lands' End's earnings goal was attainable."\textsuperscript{138}

The court then held that the statements, which had been repeated in documents filed with the SEC, were within the Safe Harbor and that the slight deviation of the 10\% five-year goal from the internal forecasts for the first year was inadequate to support an inference that the goal lacked a reasonable basis.\textsuperscript{139} The court did not attempt to harmonize the Bespeaks Caution Doctrine with the scope of the Safe Harbor. Moreover, the court implied that, under the Bespeaks Caution Doctrine, the statements would not have been actionable if Lands' End had stated that they were speculative and might not be achieved.

\textsuperscript{133} \textit{Id.} at 245-46.
\textsuperscript{134} 965 F.2d 1411 (7th Cir. 1992).
\textsuperscript{135} \textit{Id.} at 1416-17.
\textsuperscript{136} \textit{Id.} at 1414-15.
\textsuperscript{137} \textit{Id.} at 1417; see also supra note 117 and accompanying text. \textit{But see In re Allergan Inc. Sec. Litig., [Current] Fed. Sec. L. Rep. (CCH) \textsuperscript{138} 98,066, at 98,061 (C.D. Cal. Nov. 29, 1993) ("[The defendant's] statement that the Company 'believed' that sales growth in the mid-teens over the [three to five-year] planning period' [sic] was an 'achievable goal' or 'objective' was inherently uncertain and plainly not actionable.").}
\textsuperscript{138} \textit{Roots(175,825),(936,835)
\textsuperscript{139} \textit{Id.} at 1418.
The Bespeaks Caution Doctrine

H. Third Circuit

The Third Circuit adopted the Bespeaks Caution Doctrine in In re Donald J. Trump Casino Securities Litigation.140 The plaintiffs were holders of bonds that had been issued in November 1988 as the primary funding of a hotel/casino, which was opened in April 1990.141 The prospectus for the bonds acknowledged that funds from the offering and other sources were to fund interest payments on the bonds for the first fifteen months.142 Within three months of the opening of the hotel/casino, the issuer tentatively proposed to restructure the debt143 and, later in the year, began negotiating a restructuring with the bondholders.144

The prospectus for the bonds stated, "The Partnership believes that funds generated from the operation of the [hotel/casino] will be sufficient to cover all of its debt service (interest and principal)."145 The prospectus identified the following risk factors, among others: (i) that the first interest payment on the bonds not paid from the initial financing would occur before the peak season, (ii) that the hotel/casino had no operating history, (iii) that the hotel/casino had approximately twice the room capacity and casino space of many existing casinos, and no operator had experience running a casino of that size in that city, (iv) that some competitors were renovating their facilities, and (v) that revenue growth was expected to be restrained by the local transportation system.146 The prospectus also stated that there could be no assurance that actual operating results would meet the disclosed expectations.147 The plaintiffs alleged that the prospectus was misleading, because, inter alia, (i) the statement that debt service could be met was not believed in good faith and supported by a reasonable basis, (ii) the prospectus failed to state that the casino would be required to win approximately $1.3 million per day if the casino were to have sufficient cash flow to pay its debts,148 and (iii) the prospectus failed to compare the hotel/casino’s high debt-equity ratio to those of other casinos.149

The court stated, "As we see it, 'bespeaks caution' is essentially shorthand for the well-established principle that a statement or omission must be considered in context, so that accompanying statements may render it immaterial as a matter of law."150 The court affirmed the dismissal of the claims under Federal Rule of Civil Procedure

140. 7 F.3d 357 (3d Cir. 1993).
141. Id. at 364-65.
142. Id. at 364.
145. Trump, 7 F.3d at 365.
146. Id. at 370. The opinion also noted that the bonds had a stated rate of interest 500 basis points over the rate of “quality” corporate bonds, suggesting that the price of a security may warn investors that the security is risky. Id. at 364. A similar approach was taken by the plaintiffs in In re VeriFone Securities Litigation, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,820, at 98,073 n.7 (9th Cir. Nov. 17, 1993), who alleged that the price at which stock was sold in an initial public offering was a prediction, because the defendants relied on future prospects in setting the price. That approach seems inconsistent with the notion that the federal securities laws regulate disclosure and are not merit regulation.
147. Trump, 7 F.3d at 371.
148. Id. at 374.
149. Id. at 375.
150. Id. at 364.
12(b)(6), holding that "given this extensive yet specific cautionary language, a reasonable factfinder could not conclude that the inclusion of . . . [the statement that the issuer believed it could meet its debt service] would influence a reasonable investor's investment decision." The court construed Virginia Bankshares as meaning that "when the subject of a misrepresentation or omission is such that the accompanying language does not diminish the importance of the misrepresentation or omission to the investor, the misrepresentation or omission remains actionable," and concluded that its approach was consistent with Virginia Bankshares.

Although the lengthy risk factors seem almost to bury the estimate, and therefore preclude its being the basis of any action, an alternative perspective indicates that the prospectus was inadequate. The prospectus properly identified various facts known at the time the prospectus was issued that a prospective investor might find material in weighing an investment decision. This disclosure was not required by inclusion of the opinion concerning the ability to meet debt service. Those risks were material and should have been included in any event.

However, the issuer went further and released an opinion and thereby became obligated to assure that the opinion was prepared with a reasonable basis. For the opinion not to have been actionable, either (i) the disclosure must have conveyed that the opinion was not prepared with a reasonable basis or (ii) there must have been insufficient evidence to permit an inference that the opinion was not prepared with a reasonable basis. The risk factors did not indicate that the opinion was not prepared with a reasonable basis. Rather, a reader would have concluded that those factors were weighed in reaching the opinion. The plaintiffs also alleged information that implied that the opinion was not prepared with a reasonable basis. The plaintiffs alleged that the hotel/casino had to win $1.3 million per day if the debt service were to be met. That required win was approximately five times the average area casino win, although the hotel/casino had only twice the room capacity and casino space of many existing local casinos. Although the court correctly stated that "[t]he federal securities laws do not ordain that the issuer of a security compare itself in myriad ways to its competitors," those competitive comparisons are necessary to permit a critical analysis of estimates voluntarily disclosed by a company concerning the performance of new operations. The plaintiffs alleged information that implied that the estimate was based on very optimistic assumptions, and the prospectus failed to identify the estimate as optimistic and omitted information that would have facilitated investors' understanding of that fact. In such a context, dismissal of the complaint under Federal Rule of Civil Procedure 12(b)(6) was not warranted.

151.  Id. at 369.
153.  Trump, 7 F.3d at 373.
154.  Id. at 374.
156.  Trump, 7 F.3d at 370. The prospectus also suggested that casino win per square foot was a relevant basis for analyzing a hotel/casino, as the prospectus included that measure in another discussion. See id.
157.  Id. at 375.
III. APPLICATION OF THE OBLIGATION TO PLEAD FRAUD WITH PARTICULARITY TO CLAIMS CONCERNING OPINIONS OR ESTIMATES

Federal Rule of Civil Procedure 9(b) (Rule 9(b)) provides: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally." All circuits have held that this requirement applies to causes of action alleging violation of section 10(b) of the 1934 Act, although its application to causes of action under section 11 or 12(2) of the 1933 Act, which do not have scienter as an element, is unresolved. Courts have not applied Rule 9(b) uniformly to actions alleging federal securities law claims. In certain circumstances, the Rule has been applied in a manner that effectively forecloses any cause of action. This rule of pleading can have especially harsh consequences for plaintiffs alleging that estimates or opinions violated the disclosure requirements of federal securities laws.

As applied to complaints alleging violation of the federal securities laws in which scienter is an element, Rule 9(b) applies to both the allegation that there was a false or misleading statement and the allegation of scienter. As to the false or misleading statement, the Rule requires that the complaint: (i) specify the statements that are allegedly false or misleading; (ii) specify which defendant made each allegedly false or misleading statement (or made the omission); (iii) specify when and where each false or misleading statement was made (or omitted); and (iv) specify the manner in which the statement (or omission) mislead the plaintiff. Where the claims arise from an allegedly false or misleading offering document, identification of the document is adequate to specify the time and place of the statement as to defendants who are affiliates or other insiders with respect to the offering in question, and statements in the document need not be attributed to particular individual defendants. However, false or misleading statements included in a document filed with the SEC may not be charged

159. Shapiro v. UJB Fin. Corp., 964 F.2d 272, 288 (3d Cir.) (holding that where a complaint seeking relief under § 10(b) of the 1934 Act as well as § 11 or 12(2) of the 1933 Act alleges fraud with respect to both provisions, Rule 9(b) applies to the 1933 Act claims; reserving the issue of whether Rule 9(b) would apply if the 1933 Act claims were not grounded in fraud), cert. denied, 113 S. Ct. 365 (1992); accord Anderson v. Clow, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,807, at 97,990 (S.D. Cal. Sept. 17, 1993); Maywalt v. Parker & Parsley Petroleum Co., 808 F. Supp. 1037, 1052 (S.D.N.Y. 1992); Lucia v. Prospect Street High Income Portfolio, Inc., 769 F. Supp. 410, 416-17 (D. Mass. 1991); see also In re GlenFed, Inc. Sec. Litig., 11 F.3d 843, 850 (9th Cir. 1993) ("When § 11 and § 12 claims are grounded in allegations of fraud . . . the allegations must meet the requirements of Rule 9(b). "). Shapiro and GlenFed present a trap for plaintiffs seeking relief under both the 1933 Act and 1934 Act; by incorporating the same set of factual allegations into the separate counts alleging violations of these two acts, a plaintiff may unintentionally impose on himself or herself unnecessary and unwarranted procedural obstacles for the claims under the 1933 Act. See also In re AnnTaylor Stores Sec. Litig., 807 F. Supp. 990, 1003 (S.D.N.Y. 1992) ("Since plaintiffs disavow any claims of fraud or mismanagement in Count I [alleging violation of § 11], it need not comply with Rule 9(b) . . . .").
162. Ouaknine v. MacFarlane, 897 F.2d 75, 80 (2d Cir. 1990).
against outside directors who signed the document solely by virtue of their having signed the document.\footnote{163} Where the claims relate to projections, to meet the third element of the test, the “plaintiff must plead non-conclusory facts that, if true, would demonstrate that the projections were false when made,”\footnote{164} which should be equally applicable to claims concerning other opinions or estimates.

With respect to the allegation of scienter, courts have formulated various tests. These have included that plaintiffs must “specifically plead those events’ which ‘give rise to a strong inference’ that defendants had an intent to defraud, knowledge of falsity, or a reckless disregard for the truth,”\footnote{165} that scienter can be adequately alleged by showing a motive and opportunity for committing fraud (for example, sales by insiders\footnote{166}), and that the plaintiff must “identify circumstances indicating conscious behavior by the defendant, though the strength of the circumstantial allegations must be correspondingly greater.”\footnote{167} Fraud on a relatively large scale also may sufficiently suggest that failure to know of the fraud only could have resulted from reckless conduct.\footnote{168}

In considering these cases, it is important to recognize that the significance of an improper motive is that it may imply that a defendant had a reason to disseminate inaccurate information. However, an improper motive is not a required element. There is a cause of action under Rule 10b-5 against a defendant who disseminates materially false information with knowledge that the information is false even if the defendant derives no personal benefit from the deception.

Another court collapsed the separate requirements of pleading the falsity of projections and the required specificity with which scienter must be pled, stating: “[P]laintiffs need not necessarily allege the specific information at defendants’ disposal at the time the projections were made. However, plaintiffs must accompany their allegations with facts indicating why the charges against defendants are not baseless and why additional information lies exclusively within defendants’ control.”\footnote{169} A subsequent opinion in that circuit stated that in securities law actions alleging fraud, the element of scienter will be adequately pled if the plaintiff alleges a belief that information demonstrating scienter “lies in defendants’ exclusive control” and the plaintiff has “thoroughly investi-
gated" all public sources for the information before filing the complaint.\textsuperscript{170}

The various approaches summarized above are not exhaustive.\textsuperscript{171} Although courts have noted that application of Rule 9(b) before discovery to claims alleging federal securities fraud must be made in a manner that does not permit "sophisticated defrauders" to escape liability,\textsuperscript{172} the Rule has nevertheless been applied by some courts in a manner that effectively prevents plaintiffs from proceeding with proper claims.

The court in \textit{Vachon v. BayBanks, Inc.},\textsuperscript{173} dismissed under Rule 9(b) claims alleging that a bank's characterizations of its loan loss reserves in a deteriorating economy as "adequate" and its lending practices as "conservative" and "careful" were false and misleading where the bank had reserves significantly less than comparable banks.\textsuperscript{174} Concerns underlying Rule 9(b) in the context of a federal securities law suit include avoidance of strike suits,\textsuperscript{175} guarding a defendant's reputation from baseless charges of fraud,\textsuperscript{176} and providing a defendant with fair notice of the claims.\textsuperscript{177} These rationales are not implicated where the complaint supports a claim that references to reserves as "adequate" and to lending practices as "conservative" were misleading by including allegations that competitors had approximately 40\% larger reserves.\textsuperscript{178}

In \textit{In re GlenFed, Inc. Securities Litigation},\textsuperscript{179} the court weighed the facts alleged by the plaintiffs and the defendants and concluded that the requirements of Rule 9(b) had not been met.\textsuperscript{180} To support an allegation that the defendants' representation that the company intended to sell three subsidiaries were false, the plaintiffs identified an internal strategic plan that stated that one subsidiary could not be viably sold.\textsuperscript{181} This claim was dismissed under Rule 9(b), because "almost contemporaneous" board minutes


\textsuperscript{171} See, e.g., Shushany v. Allwaste, Inc., 992 F.2d 517, 521 (5th Cir. 1993) ("What constitutes 'particularity' will necessarily differ with the facts of each case and hence the Fifth Circuit has never articulated the requirements of Rule 9(b) in great detail.") (quoting Guidry v. Bank of LaPlace, 954 F.2d 278, 288 (5th Cir. 1992)). The futility of rationalizing the various approaches is evident from the fact that, as noted by one group of commentators, different courts reached different conclusions concerning compliance with Rule 9(b) of two identical complaints. Richman et al., \textit{supra} note 160, at 973 n.80. Cf. \textit{In re Leslie Fay Cos., Inc. Sec. Litig.}, \textit{[Current] Fed. Sec. L. Rep. (CCH)} \textsuperscript{1} 98,031, at 98,361 n.1 (S.D.N.Y. Oct. 27, 1993).


\textsuperscript{174} \textit{id.} at 80-82 (addressing a bank that, in the first quarter of 1990 after making the allegedly misleading statements, had doubled its loan loss reserves to 51\% of its nonperforming loans while most other banks had set reserves of approximately 70\% of nonperforming loans by the Fall of 1989).

\textsuperscript{175} Romani v. Shearson Lehman Hutton, 929 F.2d 875, 878 (1st Cir. 1991); Richman et al., \textit{supra} note 160, at 979.

\textsuperscript{176} O'Brien v. National Property Analysts Partners, 936 F.2d 674, 676 (2d Cir. 1991); Richman et al., \textit{supra} note 160, at 979.

\textsuperscript{177} \textit{O'Brien}, 936 F.2d at 676; Richman et al., \textit{supra} note 160, at 979.

\textsuperscript{178} 51\% \times 1.4 = 71.4\%. The variation was even larger from the Fall of 1989 through the first quarter of 1990, when the bank doubled its reserves. \textit{Vachon}, 780 F. Supp. at 81-82.

\textsuperscript{179} 11 F.3d 843 (9th Cir. 1993).

\textsuperscript{180} \textit{id.} at 847-49.

\textsuperscript{181} \textit{id.} at 847. The plaintiffs had been able to review some discovery materials obtained in a derivative action. \textit{id.} at 848.
discussed expected bids. The court also dismissed pursuant to Rule 9(b) claims under Rule 10b-5 that the company had falsely represented that the company's asset monitoring procedures were adequate, even though the plaintiffs alleged that the defendants did not have current appraisals for some properties. Such weighing of the evidence should not be used by a court in considering motions addressing the sufficiency of the pleadings.

In Mclnnis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., the court dismissed claims alleging that an accounting firm acted fraudulently in preparing a feasibility study. The study's results were included in a disclosure document that assumed annual inflation rates ranging from 9% to 12%, while the rate of inflation for the year immediately preceding the issuance of the document was 6.1%. Where projections are prepared on the basis of information that is not firm-specific and is more favorable than the most recent historical information, permitting a plaintiff to proceed with discovery does not create a large risk of unwarranted suits. These suits could be avoided by disclosure of projections prepared on the basis of the most recent historical data or at least by disclosing a basis for using assumptions other than the most recent historical information. Moreover, without discovery, a plaintiff in this circumstance generally will be unable to become aware of additional facts supporting the allegation that assumptions, whose use on their face seem unwarranted, were selected with scienter.

Rule 9(b) has also been construed in a manner that requires complaints to identify in great detail other evidence that may not be customarily available to plaintiffs at the time the complaint is filed. In Arazie v. Mullane, the plaintiffs alleged that a company's Quarterly Report on Form 10-Q for the quarter ended March 30, 1990, was misleading, as it stated that there could be no assurance that an identified new competitor would not have a long-term adverse effect on the operating results of two of the company's properties, although an internal memorandum allegedly indicated that increased competition in April 1990 would cause a dramatic decline in revenues. The plaintiffs also alleged that the next Quarterly Report, in which the company stated that it believed that it would be able to meet debt service payments, was misleading, because internal memoranda allegedly indicated that the company would be in default under certain debt covenants. The court held that the requirements of Rule 9(b) were not met, because the plaintiffs did not state who prepared the memoranda, when

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182. Id.
183. Id. at 849.
185. Id. at 1358-59.
186. 2 F.3d 1456 (7th Cir. 1993).
187. Id. at 1462-63.
188. Id. at 1463. The opinion does not clarify the time the default was projected to occur. A projection of a default occurring a number of years in the future might be too uncertain to be material. However, the court's failure to address that issue indicates that the timing of the default was not the reason that the claims were dismissed.

The company's lack of candor was also manifested in a public statement issued in connection with a stock-for-debt swap commenced in the second quarter of 1990. The company's CEO publicly stated that the company "chose to use stock rather than cash in the offer . . . because it needed cash for various expansion projects this year." Id. at 1462.
they were prepared, the firmness of the numbers contained in the memoranda, and the names of the company's employees who reviewed the memoranda.\footnote{Id. at 1467. A similar conclusion was reached in Anderson v. Clow, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) \$ 97,807, at 97,993 (S.D. Cal. Sept. 17, 1993), in which the court dismissed under Rule 9(b) claims that misleading projections were released at roadshow presentations. The court stated that the claims, which named the defendants who allegedly made the improper statements, were "woefully inadequate," because the complaint did not specify the time or place of the roadshow presentations. \textit{Id}. One would expect that those meetings would be sufficiently prominent in the memories of the participants that alleging the dates and places of the presentations would not be of any benefit to the defendants.}

It is appropriate to require plaintiffs to identify in the complaint the statements that are allegedly misleading, in order to give the defendants notice of the claims against them. However, \textit{Arazie} holds that plaintiffs must specify in those terms information proving that the defendants had knowledge that the Quarterly Reports were false. This requirement conflicts with the terms of Rule 9(b), which permits knowledge to be averred generally. The existence of the memoranda\footnote{The opinion does not imply that the allegations concerning the contents of the memoranda were manufactured by the plaintiffs, \textit{i.e.}, that the memoranda did not exist. A naked assertion that a reporting company had prepared internal memoranda that contradicted information that the company disseminated would not add support to a claim that the information was misleading and disseminated with scienter.} surely negates any suggestion that the action was a strike suit, \textit{i.e.}, that on its face it had no merit. Perhaps the plaintiffs, after full discovery and a trial, would have been unable to meet their burden of demonstrating that the Quarterly Reports were disseminated recklessly or with knowledge that they were false. The fully developed evidence might have indicated that the memoranda had been prepared on discredited assumptions or were otherwise properly disregarded. That possibility does not justify dismissing claims under Rule 9(b) before the evidence has been fully developed.

Another court declined to require the specificity contemplated by \textit{Arazie}. In \textit{In re Wells Fargo Securities Litigation},\footnote{[Current] Fed. Sec. L. Rep. (CCH) \$ 98,007 (9th Cir. Dec. 29, 1993).} the defendants, a bank holding company and some of its executives, argued that the complaint did not meet the requirements of Rule 9(b). The complaint identified loans to nine borrowers whose precarious financial position allegedly merited an increase in the bank's loan loss reserves.\footnote{\textit{Id.} at 98,252.} The court was not persuaded by the defendants' argument that the complaint was defective because it did not identify the principal amount of those loans, the date the loans were extended, whether the loans were in default, and when the reserves should have been established.\footnote{\textit{Id.}} Deciding whether the court's holding is correct requires identification of the rationale underlying Rule 9(b). If the purpose of Rule 9(b) is to give defendants notice of the claim, it makes no sense for a court to require a complaint to set forth information that is easily accessible to the defendants through a review of their internal financial records.\footnote{\textit{Id.}}
In the recent First Circuit case of Greenstone v. Cambex Corporation, the court dismissed claims alleging that Cambex inaccurately disclosed its financial position by not disclosing certain contingent liabilities. Cambex was in the business of selling computer boards. The transactions required the customers' old computer boards to be delivered to Cambex. Some of Cambex's customers did not own, but were merely lessees of, the computers in which the customers had installed the new boards. Cambex quickly settled a suit filed by the lessor arising from Cambex's failure to return the leased computer boards in some cases and its sublease of the boards in other cases. The court dismissed the federal securities law claims alleging that Cambex should have disclosed its potential liability to the lessor, holding that there was an inadequate allegation of facts supporting the conclusion that the company "knew of a significant possibility of loss."

This decision is extraordinary. The company's failure to investigate this possible problem in the context of disclosing its financial position is the type of closing one's eyes to a potential problem that is at the core of the definition of reckless conduct. The court noted that the complaint did not quote the language of the leases. Failure to allege the terms of the leases, which might not have been publicly available, should not have prevented the claim from proceeding to discovery. The fact that the suit with the lessor was quickly settled for a large amount of money amply supports the inference that the reporting company's actions violated the leases.

Other courts have applied Rule 9(b) less restrictively. One court held that fraud was adequately pled where the complaint recited that the defendant had a significant financial interest in the issuer and participated in the preparation of allegedly misleading financial projections based on assumptions that the defendant could have readily verified. Another court held that the requirements of Rule 9(b) were met where the nature of the alleged misstatements, which included utilization of production capacity and regulatory problems with the Food and Drug Administration, suggested that the prob-

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195. 975 F.2d 22 (1st Cir. 1992).
196. Id.
197. Id. at 23.
198. Id. at 28. The court declined to decide whether contingent liabilities may be required to be disclosed under the 1934 Act and Regulation S-K even if they are not required to be disclosed in the financial statements under applicable accounting standards. Id. See generally Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 6835, 43 SEC Docket (CCH) 1330, 1335 n.27 (May 18, 1989) ("MD&A mandates disclosure of specified forward-looking information, and specifies its own standard of disclosure—i.e., reasonably likely to have a material effect . . . . The probability/magnitude test for materiality in Basic, Inc., v. Levinson, 108 S. Ct. 978 (1988), is inapposite . . . .").
199. Consider, for example, whether a company in the business of selling and installing car stereos would contemplate replacement of the radio in a leased car at the request of the lessee, and sell the removed radio to a third party, without reviewing the terms of the lease or obtaining the rental agency's approval. Of course, a lease might give the lessee the right to replace components. However, only by reviewing the lease could the existence of that power be confirmed.
201. The defendant was a sublessor to oil and gas partnerships, the interests in which were sold to the plaintiffs. The plaintiffs alleged that projections overstated the size and profitability of the oil reserves. The court stated that as sublessor, the defendant had "ready access to the actual condition of the drilling properties." Griffin v. McNiff, 744 F. Supp. 1237, 1245-46 (S.D.N.Y. 1990), aff'd, 996 F.2d 303 (2d Cir. 1993).
lems were ongoing and therefore must have been known by the company at the time falsely optimistic statements were made.\textsuperscript{202} A third court held that knowledge of undisclosed quality control problems was adequately pled where the defendants had stated that they had remedied quality control problems in the preceding year.\textsuperscript{203}

The cases summarized above demonstrate the effect Rule 9(b) can have preventing redress for meritorious allegations concerning estimates or opinions. In addition, application of Rule 9(b) to opinions or estimates within the Safe Harbor is inconsistent with the assumptions underlying the SEC's decision to place the burden of persuasion in the Safe Harbor on plaintiffs.\textsuperscript{204}

IV. ANALYSIS OF THE BESPEAKS CAUTION DOCTRINE

The discussion set forth in Part II organized the developments in accordance with the various circuits, which is necessary because the circuits' development of the Bespeaks Caution Doctrine has not been entirely consistent. However, the issues may be clarified by noting certain common themes and some related issues. Other aspects of the Bespeaks Caution Doctrine that, as of this time, have been raised only by opinions of district courts also merit attention.

A. Disclosure of Predictions and Cautionary Language Discharging the Obligation to Disclose Other Material Information

Cautionary language of the type considered by courts applying the Bespeaks Caution Doctrine can perform two functions. The contingent nature of a forward-looking statement may not be obvious. For example, a statement concerning sales during a future period could be under contract and therefore very likely to occur. Cautionary language can confirm that the statement reflects an estimate or opinion. That information can be conveyed explicitly by stating that there can be no assurance that the subject of the estimate or opinion will occur. The information also can be conveyed implicitly by identifying factors that could make the subject of the estimate or opinion not occur. In addition, the cautionary language can facilitate analysis of the likelihood that the estimate or opinion will prove to be correct by stating the assumptions made, identifying events (i.e., risk factors) that might cause the assumptions not to be accurate, and by providing presently known facts that permit analysis of the likelihood and the magnitude of the impact of the events. In such a context, it is proper for a court to hold that no reasonable investor would have believed that the results predicted in an estimate were assured.

However, the cases decided by the Courts of Appeals have identified certain circumstances in which the Bespeaks Caution Doctrine may prevent prosecution of meritorious claims. Disclosure of negative material information does not negate the ability of unreasonably prepared estimates to mislead investors. Unless an opinion or estimate expressly states that it is based on assumptions that conflict with other, negative infor-

\textsuperscript{204} See supra text accompanying notes 36-37.
mation that has been disclosed, the investing public may properly expect that the negative information has been considered in the preparation of the estimate or opinion. 205 Similarly, disclosure that there can be no assurance that a negative event will not occur does not satisfy the obligation to disclose material information that would permit investors to weigh the likelihood of that event. 206 Courts also must be careful in labeling information as a prediction. Companies should not succeed in omitting material, factual information by emphasizing that the information’s relevance derives from the extent to which it facilitates analysis of future events. 207

B. Restriction of Bespeaks Caution Doctrine to Financial Information

Statements expressing opinions or estimates concerning a variety of matters can be helpful to analysts and others valuing securities. Courts considering the scope of the type of disclosure to which the Bespeaks Caution Doctrine should apply have not presented compelling reasons for concluding that disclosure of certain types of opinions or estimates should not be encouraged.

In Ballan v. Upjohn Company, 208 the defendant had allegedly optimistically described the safety and effectiveness of a drug that the defendant manufactured, but the defendant failed to disclose promptly to either the investing public or the FDA adverse information concerning the drug. 209 The court stated: “Reliance, in my judgment, on Sinay and In re Apple is misplaced because the instant case does not involve a claim for false economic projection.” 210

Ballan has not provided a compelling basis for distinguishing the actionability of disclosure of an opinion or estimate based on whether the opinion addresses financial statement items. The value of an opinion to a person analyzing the value of a security derives from the extent to which it permits analysis of the financial return from the security. Therefore, any material opinion or estimate, regardless of its subject matter, is only relevant to the extent it permits inferences concerning financial information. Moreover, to the extent a financial projection is based on estimates concerning information such as the safety of a product, it would be anomalous to encourage disclosure of the financial projection, but not disclosure solely of an underlying opinion. Although it might be appropriate to exclude certain opinions from the Bespeaks Caution Doctrine if they were unusually likely to be inaccurate (or were unusually likely to convey an incorrect sense of precision), 211 Ballan did not identify such a basis. A better basis for reaching the same conclusion in Ballan is that the disclosure of an opinion did not obviate the need to disclose a material fact bearing on the opinion—the other information concerning the drug. 212

205. See supra notes 140-57 and accompanying text.
206. See supra notes 60-62, 86-112, 140-57 and accompanying text.
207. See supra notes 86-106 and accompanying text.
209. Id. at 1379.
210. Id. at 1382.
211. An opinion concerning future results of research in a new technology might be such an area.
212. See supra notes 205-07 and accompanying text.
The court in *In re Donald J. Trump Casino Securities Litigation*\(^\text{213}\) drew an ambiguous distinction:

We do note the troubling possibility that the "bespeaks caution" doctrine will encourage management to conceal deliberate misrepresentations beneath the mantle of broad cautionary language. It is for this reason that the "bespeaks caution" doctrine applies only to precise cautionary language which directly addresses itself to future projections, estimates or forecasts in a prospectus. A blanket warning that the within investment is "risky," for example, would be insufficient to ward against a federal securities fraud claim. Nor would our holding here apply to cautionary language regarding actual facts, such as past performance of an existing investment or the contents of appraisals or other expert reports referenced in the prospectus.\(^\text{214}\)

As noted above,\(^\text{215}\) the basis for the doctrine is that liability should not be imposed with respect to disclosure derived from the good faith, reasonable exercise of judgment. This rationale applies to estimates of future performance as well as statements of present financial condition to the extent they represent the exercise of judgment.\(^\text{216}\) However, as implied by the language in *Trump* quoted above, the doctrine should not be applied to estimates or opinions where the company disseminating the disclosure could have confirmed the disclosure's accuracy but failed to do so.

**C. Facts Implying Absence of Good Faith or a Reasonable Basis**

The cases considering claims alleging that dissemination of opinions or estimates violated federal securities laws have presented a number of patterns that suggest the estimate or opinion was not disseminated in good faith with a reasonable basis. Facts supporting that an opinion or estimate was not made in good faith include omission of alternative, less favorable opinions or estimates and a change in an estimate or opinion to one that is more optimistic coinciding with an increased desirability of optimistic information.\(^\text{217}\) By disclosing a projection, a reporting company is not only understood


\(^{214}\) Id. at 554.

\(^{215}\) See supra note 1 and accompanying text.

\(^{216}\) See generally Brudney, supra note 1, at 728 n.20 (considering whether depreciation and backlog represent statements concerning the present or the future).

\(^{217}\) In Folger Adam Company v. PMI Industries, Inc., 938 F.2d 1529, 1531 (2d Cir.), cert. denied, 112 U.S. 587 (1991), drafts of an offering memorandum prepared by an investment bank concerning the sale of two subsidiaries had included unfavorable projections, which were removed from the final memorandum at the parent corporation's request. The purchaser was advised before the purchase of an earnings estimate 38% higher than the original estimate. The court stated:

[The defendants] argue that because the... projections were not compiled with "substantial certainty," they were not material facts that needed to be disclosed in the course of the... transaction. Because [the plaintiff's] witness may be able to persuade a correctly instructed jury that the... projections were accurate statements of [the subsidiaries'] future that were intentionally concealed, however, we cannot find that appellees' conduct was immaterial as a matter of law.

*Id.* at 1534. The court's focus on whether the omitted projections were compiled with "substantial certainty"
to have a reasonable basis for the projection, but is also understood to be presenting its good faith, best estimate. Omission of a second, equally plausible estimate implicates the same concerns as an express mischaracterization of an estimate, such as a failure to state that an estimate represented a "best case." Each is in essence a claim that the estimate or opinion was not properly described, and they differ solely in that one breaches an implied description while the other breaches an express description. Each demonstrates an intent to mislead. Circumstances supporting the inference that a change in an opinion was made in bad faith by showing a motive include that a reporting company is engaged in a proxy fight or that the company is making a securities offering.

As noted above, scienter is an element of claims under Rule 10b-5 but not of claims under section 11 of the 1933 Act. Where it is alleged that an estimate or opinion was not disseminated in good faith, the proof required to prevail in the claim should not depend on whether the claims are grounded on the 1933 Act or Rule 10b-5, as bad faith represents an intent to deceive (which constitutes scienter).

It is difficult to state concisely those situations in which omission of the assumptions sufficiently indicates bad faith to warrant withholding application of the judicially created safe harbor of the Bespeaks Caution Doctrine. Cases have presented examples of circumstances in which assumptions should be disclosed. For material projections in disclosure documents concerning operations without any prior operations, assumptions concerning general economic factors, such as inflation, should be disclosed if they are substantially more optimistic than the most recent historical information. And the corresponding impact on the estimate or opinion arising from that optimistic assumption should be disclosed.

is more appropriate in the context of determining whether a company should be required to disclose any projections. See generally Panter v. Marshall Field & Co., 646 F.2d 271, 291-93 (7th Cir.) (holding that there was no duty under Rule 10b-5 to include tentative earnings projections in a public letter issued in connection with an unsolicited takeover that disclosed recently implemented programs to improve profitability and results for the preceding nine months), cert. denied, 454 U.S. 1092 (1981); Garcia v. Cordova, 930 F.2d 826, 831 (10th Cir. 1991) (holding the statement by an investment bank that a stock value could be between $40 and $100 per share, without disclosure of the basis for the figures, was too speculative and premature to be material). The material, favorable revision of the projections, especially where coupled with circumstances demonstrating an unusual benefit from favorable projections, should by itself be adequate to permit a jury to conclude that the favorable projections were made in bad faith (and should be actionable).

218. Compare Rand v. M/A-Com, Inc., 824 F. Supp. 242, 258 (D. Mass. 1992) (denying the defendants' motion for summary judgment with respect to claims founded on Rule 10b-5 concerning projections consistent with the more favorable of two internal projections prepared by the defendants) with In re Donald J. Trump Casino Sec. Litig., 793 F. Supp. 543, 567 (D.N.J. 1992) (holding that no claim against an issuer that included an appraisal in its prospectus could be based on the failure to disclose a second, less favorable appraisal obtained by a predecessor in interest), aff'd, 7 F.3d 357 (3d Cir. 1993) and Morin v. Trupin, 809 F. Supp. 1081, 1088 (S.D.N.Y. 1993) (holding claims under Rule 10b-5 were not pled with the specificity required by Rule 9(b) where an affidavit of a former employee of a defendant stated that a defendant "made changes in the Assumptions used in compiling the Financial Projections [on which the claims were founded] in order to make the...[o]ffering more marketable to his clients.").

219. See supra note 16 and accompanying text.

220. In this context, the word "optimistic" refers to a beneficial impact on the projection.

221. Circumstances might objectively warrant estimates based on assumptions substantially different than historical results, where recent events make historical information of less relevance. However, in those cir-
mation, any substantial deviation from the historical information without quantitative disclosure of the impact on the estimate or opinion arising from that deviation suggests conscious omission. Thus, dissemination of such an estimate or opinion would meet the falsity and scienter requirements of Rule 10b-5 as well as the falsity and absence of due diligence elements of claims under section 11 or 12(2) of the 1933 Act. Where a disclosure document contains projections based on these optimistic assumptions, the incremental cost of disclosing the assumptions and the extent to which they are optimistic is outweighed by the value of permitting persons analyzing the securities to make an independent judgment concerning the likelihood that the assumptions are warranted.  

McInnis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., is a good example of such a case. The assumptions of revenues were based on assumed inflation rates that were 50% to 100% (three to six percentage points) above the rate most recently experienced.

Similarly, for companies that are just commencing operations, projections based on undisclosed assumptions of sales or profitability greater than industry averages may be misleading. However, the court affirmed the dismissal under Federal Rule of Civil Procedure 12(b)(6) of claims that a projection based on very optimistic assumptions violated section 11 of the 1933 Act and Rule 10b-5 in In re Donald J. Trump Casino Securities Litigation. Failure to disclose that the assumptions are favorable does not convey the sense that the company is relying on superior performance to achieve those goals, and should be actionable.

Cases concerning projections prepared based on unreasonably optimistic assumptions may present circumstances in which the assumptions were selected negligently. Thus, disclosure of estimates or opinions based on those assumptions might be actionable under section 11 or 12(2) of the 1933 Act but may not meet the scienter requirement of Rule 10b-5.

cumstances, omission of the assumptions creates ambiguous disclosure, which should not be encouraged.

Even if the assumptions and their effect were disclosed, the estimate could be actionable if the assumptions were unreasonably optimistic.

The court held that this claim was not actionable as alleged, stating, "To state a claim, the plaintiffs must allege that [the defendant] knew of certain facts that could not be reconciled with its prediction that inflation rates would rise sharply . . . ." McInnis, 706 F. Supp. at 1359. The court's opinion does not state whether the disclosure document stated that the assumed inflation rates exceeded the most recent historical rates. This holding does not analyze the disclosure from the perspective of the recipients. If individuals reading the disclosure would not understand that the projections were based on the optimistic general economic assumptions, the disclosure is inadequate.

Because plaintiffs often allege claims under both the 1933 Act and the 1934 Act, some courts have analyzed both claims under the same standards. See, e.g., Krim v. BancTexas Group, Inc., 989 F.2d 1435, 1446 (5th Cir. 1993); In re Convergent Technologies Sec. Litig., 948 F.2d 507, 512 n.2, 517 (9th Cir. 1991) (referring to the case as a "fraud-on-the-market" case, even though the claims alleged violation of both § 11 and Rule 10b-5); In re Donald J. Trump Casino See. Litig., 793 F. Supp. 543, 552 (D.N.J. 1992) ("Plaintiffs are correct in stating that 'a projection that is issued without a reasonable basis is an untrue statement and actionable under § 10(b) and Rule 10b-5 if made knowingly or recklessly.' The same is true for section 11 claims.") (citations omitted), aff'd, 7 F.3d 357 (3d Cir. 1993); Ciresi v. Citicorp, 782 F. Supp. 819, 822-23 (S.D.N.Y. 1991), aff'd, 956 F.2d 1161 (2d Cir. 1992). To the extent an analysis of the materiality of and reliance on

HeinOnline -- 19 J. Corp. L. 279 1993-1994
The Bespeaks Caution Doctrine also should be inapplicable to estimates that are very sensitive to changes in the assumptions unless that fact is disclosed.\textsuperscript{227} In that context, disclosure of the sensitivity is not adequate without information giving some sense of the magnitude of the sensitivity. Proper disclosure in that context would either present a second set of projections based on alternative assumptions or indicate the effect of a specified change in the assumptions.\textsuperscript{228} Customary disclosure such as "results may vary significantly from that projected if the rates are higher or lower than expected" does not convey information permitting independent analysis, and therefore does not meet the objective of disclosure—to permit investors to make an independent judgment of the value of the securities. However, the Bespeaks Caution Doctrine should apply to estimates based on aggressive, reasonably selected, firm-specific assumptions if the nature of the assumptions is prominently disclosed.\textsuperscript{229} The failure to disclose that such an estimate is highly sensitive to changes in assumptions, however, might be actionable.\textsuperscript{230}

Cases often arise involving claims against a third party whose report or opinion, included in the relevant disclosure document, allegedly is based on unreasonable assumptions provided by the issuer. These cases have primarily concerned tax opinions and reports on projections or pro forma information.\textsuperscript{231} Courts have held these parties an opinion or estimate accompanied by cautionary language in a claim under Rule 10b-5 incorporates an assessment of whether the opinion was disseminated recklessly (i.e., one test is applied to determine compliance with the various elements), this treatment is inconsistent with the existence of varying elements of actions under the two Acts. Cf. In re VeriFone Sec. Litig., [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,820, at 98,071 (9th Cir. Nov. 17, 1993) ("Shareholders argue that the district court improperly 'lumped' their claims under 11 of the '33 Act with their claims under 12(2) of the '33 Act and 10(b) of the '34 Act (and Rule 10b-5 thereunder) . . . . [T]hey maintain that a 'duty to disclose' analysis is irrelevant with respect to 11 . . . . [W]e interpret the district court's discussion of a 'duty to disclose' as bearing on whether they adequately allege a material misrepresentation or omission, a question common to all statutory provisions at issue in this case.").

\textsuperscript{227} Such an omission was alleged in Nichols v. Merrill Lynch, Pierce, Fenner & Smith, 706 F. Supp. 1309, 1348 n.18 (M.D. Tenn. 1989).

\textsuperscript{228} See \textit{generally} Proposed Guides for Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5699, 41 Fed. Reg. 19,986, 19,987 (1976) ("In weighing the advantages and disadvantages of disclosing projections and in determining the period and format of projections, management should not be guided solely by its ability to forecast a single net income figure. Investors may be provided with useful information by the presentation of ranges or alternative estimates based on various assumptions about future events.").

\textsuperscript{229} Cf. O'Brien v. National Property Analysts Partners, 936 F.2d 674, 677 (2d Cir. 1991) (discussing a complaint concerning a document disclosing assumptions of increased sales by tenants of the issuer, whose revenues were based on those sales).

\textsuperscript{230} The nature of this type of estimate can yield circumstances in which the failure to know of its sensitivity is not reasonable but does not rise to the level of reckless conduct. The culpability standard applies to whether the sensitivity should have been known. If that information were known, its omission would be intentional and therefore meet the requirements for liability under both §§ 11 and 12(2) of the 1933 Act as well as under Rule 10b-5.

not liable where their report or opinion was not based on reasonable assumptions, or was based on extraordinarily favorable assumptions and the report was accompanied by statements disclaiming responsibility for the assumptions. Disclaimers such as the firm "relied on assumptions without verifying the data" do not convey that the firm might be recklessly disregarding the inappropriate selection of assumptions. These courts have identified no reason why disclaimers that do not clearly explain that they extend to reckless conduct or intentional misconduct should be construed to apply in such cases, and are inconsistent with the policy of full and complete disclosure underlying the federal securities laws.

Conditioning application of the Bespeaks Caution Doctrine on disclosure of assumptions underlying earnings estimates of companies with operating histories is more complex. Estimates based on optimistic assumptions that would be actionable by themselves may not be actionable in the context of prior annual and quarterly reporting of plans and expectations that could provide a context in which investors should understand that assumptions are optimistic. At a minimum, where estimates are based on a company’s plans or on trends identified by the company, it is inconsistent for a company to take the position that the plans or trends are insufficiently certain to be required to be disclosed and then nevertheless release estimates based on those plans or trends.

D. Claims Implicating Mismanagement

In *Santa Fe Industries, Inc. v. Green*, the Supreme Court held that minority shareholders did not have a cause of action under Rule 10b-5 for allegations that the consideration to be received in a freeze-out merger was inadequate where the information statement for the merger contained no omissions or misstatements. The court stated: "Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement." The Court distinguished cases “in which the breaches of fiduciary duty held violative of Rule 10b-5 included some element of deception.”


232. *See, e.g.*, McInnis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 706 F. Supp. 1355, 1359 (M.D. Tenn. 1989). *But see Stevens*, 694 F. Supp. at 1064 (holding that a tax opinion stating that it was “more likely than not that the bulk of tax benefits . . . are allowable” was actionable even though the tax opinion stated that it was based on facts supplied by the issuer).

233. Narrowly construing the scope of these disclaimers is also consistent with the judicial trend of narrowly construing the scope of contractual waivers of negligence. *Cf. 4 FOWLER V. HARPER ET AL., THE LAW OF TORTS 251 (2d ed. 1986).*

234. Policies that permit firms whose opinions or reports are included in disclosure documents to disclaim liability for reckless conduct are also difficult to harmonize with the SEC’s view that a registrant’s indemnification of officers and controlling persons for liability under the 1933 Act is unenforceable as against public policy. *See 17 C.F.R. § 229.510 (1993).* The unenforceability of such indemnification reflects a belief that it is improper to release an individual from liability for failure to fulfill a duty created by law to assure that disclosure is not false or misleading.


236. *Id. at 467, 474.*

237. *Id. at 479* (quoting Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971)).

238. *Santa Fe Indus.*, 430 U.S. at 474-75.
This doctrine has lead defendants to attempt to characterize undisclosed management practices as mismanagement, which need not be disclosed. On this basis, courts have held the following omissions, directly or indirectly relating to financial results,\textsuperscript{239} not to be actionable under the federal securities laws: that the company’s rapid expansion program was undertaken with “little or no meaningful information concerning the question of whether [the company] could profitably expand”;\textsuperscript{240} that the company expanded to businesses for which it did not have the ability and resources to manage efficiently;\textsuperscript{241} that the company had inadequate procedures to identify expansion costs and to control marketing costs;\textsuperscript{242} an absence of accounting controls and management information systems necessary to assure accuracy of reported financial information;\textsuperscript{243} a delay in writing down an asset;\textsuperscript{244} overstaffing for some types of employees coupled with understaffing as to other types;\textsuperscript{245} billing problems that delayed collections and caused customer dissatisfaction;\textsuperscript{246} that overhead was rising faster than planned;\textsuperscript{247} and that a heightened importance of marketing, as compared to historical competition on the basis of cost, would disadvantage the issuer, which could not spend as much on advertising as its competitors.\textsuperscript{248} Courts have found the following actionable if adequately supported by the facts: alleged reckless dissemination of financial statements containing “errors in calculation”;\textsuperscript{249} failure to disclose problems with inventory levels and production capacity utilization;\textsuperscript{250} failure to disclose that the success of an issuer depended on illegal marketing practices that violated consent orders,\textsuperscript{251} and dissemination of representations that quality control problems had been solved, with knowledge

\textsuperscript{239} This doctrine has been applied to disclosure not relating to financial results. See, e.g., Kas v. Financial Gen. Bankshares, Inc., 796 F.2d 508, 514-15 (D.C. Cir. 1986) (holding that the doctrine does not permit omissions of material conflicts of interest, whether or not the conflicts breach fiduciary duties); Panter v. Marshall Field & Co., 646 F.2d 271, 289 (7th Cir.) (holding that the doctrine applies to a policy of contesting all acquisition overtures, regardless of their benefits to shareholders), cert. denied, 454 U.S. 1092 (1981); Craftmatic Sec. Litig. v. Kraftsow, 890 F.2d 628, 640 (3d Cir. 1989) (rejecting application of the doctrine to a failure to disclose that the company’s marketing practices resulted in an unusually high number of customer complaints). See also In re Donald J. Trump Casino Sec. Litig., 793 F. Supp. 543, 556 (D.N.J. 1992) (“Certainly management is not required to offer investments pursuant to a prospectus which disparages the very viability of that investment.”), aff’d, 7 F.3d 357 (3d Cir. 1993). Issuers should not be required to use particularly inflammatory or derogatory language in disclosing adverse information. Id. at 559. Cf. Financial General Bankshares, 796 F.2d at 517. However, permitting companies not to disclose negative information is contrary to the full disclosure scheme of the federal securities laws.

\textsuperscript{240} Craftmatic, 890 F.2d at 632 n.5, 640.

\textsuperscript{241} Id. at 633 n.5.

\textsuperscript{242} Id.


\textsuperscript{244} Greenberg v. Howtek, Inc., 790 F. Supp. 1181, 1187 (D.N.H. 1992); United Telecommunications, 781 F. Supp. at 696-700; see also supra notes 41-48 and accompanying text.

\textsuperscript{245} United Telecommunications, 781 F. Supp. at 698, 700.

\textsuperscript{246} Id.

\textsuperscript{247} Id.

\textsuperscript{248} Id. at 699-700.


\textsuperscript{251} Craftmatic Sec. Litig. v. Kraftsow, 890 F.2d 628, 640 (3d Cir. 1989).
The Bespeaks Caution Doctrine

of their falsity. 252

Just as it is not appropriate for an issuer to fail to disclose material information on the basis that the information is reflected in a disclosed opinion or estimate, material factual information should not be omitted on the basis that the facts arose from mismanagement. Where financial statements are not accurate because the issuer has inadequate management information systems or accounting controls, the disclosure's inaccuracy should be within the scope of the federal securities laws, whether the inaccuracy arises from intentional misconduct, fraud, or negligence. Moreover, just as disclosure of projections creates an implied representation that they are made with a reasonable basis, the release of actual financial results implies that they have been prepared with a reasonable basis. The failure to disclose that actual financial results have been prepared without a reasonable basis also should be actionable. This approach is consistent with the obligation to disclose that an independent accountant recently advised a company that the internal controls necessary to develop reliable financial statements do not exist if the accountant resigned or was dismissed, 253 the expectation being that the accountant will resign if the internal controls are not satisfactorily revised.

Similarly, a company should be required to exercise in a reasonable manner its judgment in determining whether to write down assets. Those determinations involve judgments similar to those underlying projections. 254 The ongoing reporting requirements of the 1934 Act and the requirements of the 1933 Act obligate companies to exercise that judgment at specified times. The regulatory scheme created under sections 11 and 12(2) of the 1933 Act reflects a determination that the benefits to investors from requiring judgments formed in preparing disclosure to be exercised reasonably outweigh unwarranted burdens on issuers. This approach should be applied consistently in the context of the timing of write-downs. Similarly, reckless exercise of that judgment should be actionable under Rule 10b-5.

V. CONCLUSIONS

The Safe Harbor represented an experiment by the SEC aimed at encouraging wider dissemination of estimates and opinions. The Bespeaks Caution Doctrine can be viewed as a judicial extension of the principles embodied in the Safe Harbor in the absence of significant revision of the Safe Harbor since the SEC's first tentative regulatory actions in the field. The implementation of the Safe Harbor has not fostered dissemination of an excessive number of unwarranted projections. This experience supports extension of the liability limits for estimates or opinions made in good faith and with a reasonable basis under the Bespeaks Caution Doctrine to statements contained in offering documents generally circulated to prospective purchasers, whether with respect to

registered or unregistered offerings, and to statements underlying actions asserting violation of Rule 10b-5 relying on a fraud-on-the-market theory. In addition, the reported cases have not demonstrated any reason to restrict this approach to estimates or opinions concerning financial statement items.

However, the Bespeaks Caution Doctrine had its origins in a case decided before the meaning of "scienter" was fully developed. The failure of Pollin to place the doctrine in that context has been perpetuated by courts that extended the doctrine to causes of action under the 1933 Act without consideration of the absence of a requirement of scienter under section 11 or 12(2) of the 1933 Act. The difficulties that plaintiffs have pursuing meritorious claims warrant application of the doctrine—especially as to claims of which scienter is an element—only after some discovery has been permitted. In this context, a reasonable basis for an estimate or opinion requires an absence of negligence. For claims under section 10 of the 1934 Act, plaintiffs have to prove the additional element of scienter. As a result of the varying elements of claims under the 1933 Act and the 1934 Act, opinions or estimates may be actionable under the 1933 Act but not under the 1934 Act. In addition, neither disclosure of an estimate or opinion nor dissemination of mere cautionary language should discharge the obligation to disclose material underlying information.